26/PT.1 (sec.1.851-1.1200)/981 MF

code of federal regulations

Internal Revenue

ORIGINAL

COMPLETED

26

PART 1 (§§ 1.851 TO 1.1200)

Revised as of April 1, 1981

022-003-94601-2

THE NATIONAL ARCHIVES OF THE UNITED STATES
1934

code of federal regulations

Internal Revenue

26

PART 1 (§§ 1.851 TO 1.1200)

Revised as of April 1, 1981

CONTAINING
A CODIFICATION OF DOCUMENTS
OF GENERAL APPLICABILITY
AND FUTURE EFFECT

AS OF APRIL 1, 1981

With Ancillaries

Published by
the Office of the Federal Register
National Archives and Records Service
General Services Administration

as a Special Edition of
the Federal Register

1934

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1981

FOR SALE BY THE SUPERINTENDENT OF DOCUMENTS
U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON, D.C. 20402

MICROFICHE (24X)

SUBSCRIPTION PRICE: DOMESTIC-- $225.00 A YEAR,
$ 2.25 SINGLE COPY
FOREIGN -- $280.00 A YEAR
$ 2.85 SINGLE COPY

Table of Contents

Page

Explanation v

Title 26:

Chapter I—Internal Revenue Service Department of the Treasury (Continued) 3

Finding Aids:

Table of CFR Titles and Chapters 821

Alphabetical List of Agencies Appearing in the CFR 835

List of CFR Sections Affected 843

Cite this Code CFR

thus: 26 CFR 1.851-1

Explanation

The Code of Federal Regulations is a codification of the general and permanent rules published in the Federal Register by the Executive departments and agencies of the Federal Government. The Code is divided into 50 titles which represent broad areas subject to Federal regulation. Each title is divided into chapters which usually bear the name of the issuing agency. Each chapter is further subdivided into parts covering specific regulatory areas.

ISSUE DATES

Each volume of the Code is revised at least once each calendar year and issued on a quarterly basis approximately as follows:

Title 1 through Title 16	as of January 1
Title 17 through Title 27	as of April 1
Title 28 through Title 41	as of July 1
Title 42 through Title 50	as of October 1

The appropriate revision date is printed on the cover of each volume.

LEGAL STATUS

The contents of the Federal Register are required to be judicially noticed (44 U.S.C. 1507). The Code of Federal Regulations is prima facie evidence of the text of the original documents (44 U.S.C. 1510).

HOW TO USE THE CODE OF FEDERAL REGULATIONS

The Code of Federal Regulations is kept up to date by the individual issues of the Federal Register. These two publications must be used together to determine the latest version of any given rule.

To determine whether a Code volume has been amended since its revision date (in this case, April 1, 1981), consult the "List of CFR Sections Affected (LSA)," which is issued monthly, and the "Cumulative List of Parts Affected," which appears in the Reader Aids section of the daily Federal Register. These two lists will identify the Federal Register page number of the latest amendment of any given rule.

EFFECTIVE DATES

Each volume of the Code contains amendments published in the Federal Register since the last revision of that volume of the Code. Source citations for the regulations are referred to by volume number and page number of the Federal Register and date of publication. Publication dates and effective dates are usually not the same and care must be exercised by the user in determining the actual effective date. In instances where the effective date is beyond the cut-off date for the Code a note has been inserted to reflect the future effective date.

OBSOLETE PROVISIONS

Provisions that become obsolete before the revision date stated on the cover of each volume are not carried. Code users may find the text of provisions in effect on a given date in the past by using the appropriate numerical list of sections affected. For the period before January 1, 1973, consult either the List of CFR Sections Affected, 1949-1963, or 1964-1972, published in three separate volumes. For the period beginning January 1, 1973, a "List of CFR Sections Affected" is published at the end of each CFR volume.

CFR INDEXES AND TABULAR GUIDES

A subject index to the Code of Federal Regulations is contained in a separate volume, revised semiannually as of January 1 and July 1, entitled CFR INDEX AND FINDING AIDS. This volume contains the Parallel Table of Statutory Authorities and Agency Rules (Table I), and Acts Requiring Publication in the Federal Register (Table III). A list of CFR Titles, Chapters, and Parts and an alphabetical list of agencies publishing in the CFR are also included in this volume.

An index to the text of Presidential documents appears at the end of each compilation of Title 3, The President.

The Federal Register Index is issued monthly in cumulative form. This index is based on a consolidation of the "Contents" entries in the daily Federal Register.

A List of CFR Sections Affected (LSA) is published monthly, keyed to the revision dates of the 50 CFR titles.

INQUIRIES AND SALES

For a summary, legal interpretation, or other explanation of any regulation in this volume, contact the issuing agency. Inquiries concerning editing procedures and reference assistance with respect to the Code of Federal Regulations may be addressed to the Director, Office of the Federal Register, National Archives and Records Service, General Services Administration, Washington, D.C. 20408 (telephone 202-523-3517). Sales are handled exclusively by the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402.

JOHN E. BYRNE,
Director,
Office of the Federal Register.

April 1, 1981.

THIS TITLE

Title 26—INTERNAL REVENUE is composed of fourteen volumes. The Contents of these volumes represent all current regulations issued by the Internal Revenue Service, Department of the Treasury, as of April 1, 1981. The first eight volumes comprise Part 1 (Subchapter A—Income Tax) and are arranged by sections as follows: §§ 1.0–1.169; §§ 1.170–1.300; §§ 1.301–1.400; §§ 1.401–1.500; §§ 1.501–1.640; §§ 1.641–1.850; §§ 1.851–1.1200; and § 1.1201 to end. The ninth volume containing Parts 2–29, includes the remainder of Subchapter A and all of Subchapter B—Estate and Gift Taxes. The last five volumes contain as follows: Parts 30–39 (Subchapter C—Employment Taxes); Parts 40–299 (Subchapter D—Miscellaneous Excise Taxes); Parts 300–499 (Subchapter F—Procedure and Administration): Parts 500–599 (Subchapter G—Regulations under Tax Conventions); and Part 600 to end (Subchapter H—Internal Revenue Practice).

For this volume, David H. Roberts III was Chief Editor. The Code of Federal Regulations publication program is under the direction of Martha B. Girrard, assisted by Robert E. Jordan.

New Publication

List of CFR Sections Affected

(1964 through 1972)

A Research Guide

These two volumes contain a compilation of the "List of CFR Sections Affected (LSA)" for the years 1964 through 1972. Reference to these tables will enable the user to find the precise text of CFR provisions which were in force and effect on any given date during the period covered.

Volume I (Titles 1 through 27) $14.00
Volume II (Titles 28 through 50) $13.00

ORDER FORM Mail to: Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402

Enclosed is $ ________ ☐ check,
☐ money order, or charge to my
Deposit Account No.
☐☐☐☐☐☐☐–☐

Order No. ____________

Credit Card Orders Only

Total charges $________ Fill in the boxes below.

Credit Card No. ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

Expiration Date Month/Year ☐☐☐☐

Please send me ____ copies of the CODE OF FEDERAL REGULATIONS
Volume I $14.00 Stock No. 022-003-94233-5
Volume II $13.00 Stock No. 022-003-94234-3

Name—First, Last

Street address

Company name or additional address line

City State ZIP Code

(or Country)

PLEASE PRINT OR TYPE

For Office Use Only

Quantity		Charges
________	Enclosed	
________	To be mailed	
	Subscriptions	
Postage		
Foreign handling		
MMOB		
OPNR		
________	UPNS	
________	Discount	
________	Refund	

would you like to know

if any changes have been made in these regulations since the revision date of this book without reading the FEDERAL REGISTER every day? If so, you **may wish to subscribe to the LSA (List of CFR Sections Affected.).**

LSA (List of CFR Sections Affected)

$10.00
per year

The LSA (List of CFR Sections Affected) is designed to lead users of the Code of Federal Regulations to amendatory actions published in the Federal Register, and is issued monthly in cumulative form. Entries indicate the nature of the changes.

Also available on a subscription basis . . .

Federal Register Index **$8.00**
per year

Indexes covering the contents of the daily Federal Register are issued monthly in cumulative form. Entries are carried primarily under the names of the issuing agencies. Significant subjects are carried as cross-references.

A finding aid is included in each publication which lists Federal Register page numbers with the date of publication in the Federal Register.

Note to FR Subscribers: FR Indexes and the LSA (List of CFR Sections Affected) will continue to be mailed free of charge to regular FR subscribers.

Mail order form to:
Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402

There is enclosed $_________ for _________ subscription(s) to the publications checked below:

.... **LSA (LIST OF CFR SECTIONS AFFECTED) ($10.00 a year domestic; $12.50 foreign)**
.... **FEDERAL REGISTER INDEX ($8.00 a year domestic; $10.00 foreign)**

Name____

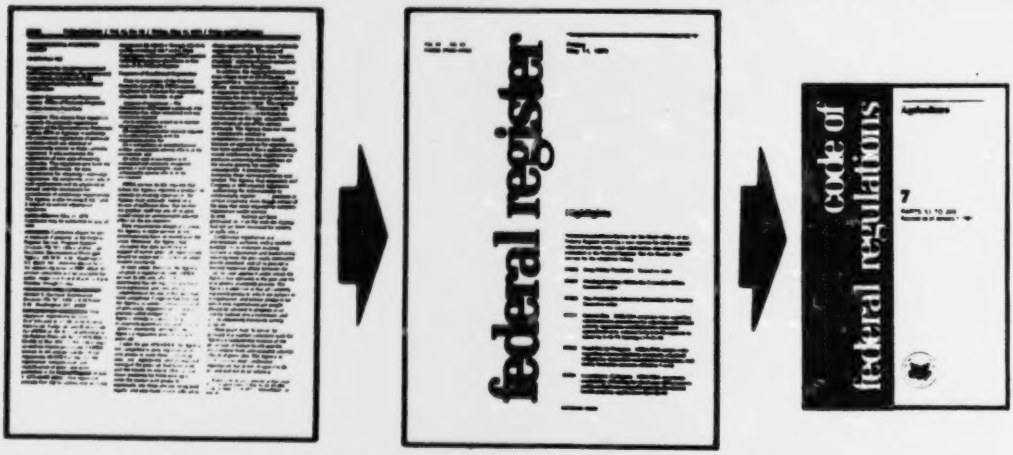
Street Address____________________________________

City__________________ State____________ ZIP__________

Make check payable to the Superintendent of Documents

The Federal Register

Regulations appear as agency documents which are published daily in the **Federal Register** and codified annually in the **Code of Federal Regulations**



The **Federal Register**, published daily, is the official publication for notifying the public of proposed and final regulations. It is the tool to use to participate in the rulemaking process by commenting on the proposed regulations. And it keeps people up to date on the Federal regulations currently in effect.

The **Federal Register** contains many reader's aids—Highlights, Grant Information, list of hearings and Sunshine meetings—which simplify the user's job.

The **Code of Federal Regulations** (CFR) contains the annual codification of the final regulations printed in the **Federal Register**. Each of the 50 titles is updated annually.

Subscription Prices:

Federal Register	**Code of Federal Regulations**
One year: $75 domestic; $145 foreign	One year: $525 domestic; $656.25 foreign
Six months: $45 domestic; $90 foreign	Single volumes: Individually priced.

ORDER FORM Mail To: Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402

Enclosed is $ __________ ☐ check, ☐ money order, or charge to my Deposit Account No.

☐☐☐☐☐☐☐–☐

Order No. __________

Credit Card Orders Only

Total charges $ __________ Fill in the boxes below.

Credit Card No. ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

Expiration Date Month / Year ☐☐☐☐

Please send me

.... **Federal Register:** $75 per year domestic; $145 foreign
$45 per six-month domestic; $90 foreign

.... **Code of Federal Regulations:** $525 per year domestic; $656.25 foreign

Name—First, Last

Company name or additional address line

Street address or additional address line

City State ZIP Code

(or Country)

PLEASE PRINT OR TYPE

FOR OFFICE USE ONLY

Quantity	Charges
Enclosed	
To be mailed	
Subscriptions	
Postage	
Foreign handling	
MMOB	
OPNR	
UPNS	
Discount	
Refund	

Title 26—Internal Revenue

(This book contains Part 1, §§ 1.851 to 1.1200)

Part

CHAPTER I—Internal Revenue Service, Department of the Treasury (continued) 1

BLANK PAGE

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY (Continued)

(Part 1, §§ 1.851 to 1.1200)

NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980.

SUBCHAPTER A—INCOME TAX (continued)

Part	
1	Income tax; taxable years beginning after December 31, 1953 (continued).

Supplementary Publications: *Internal Revenue Service Looseleaf Regulations System.*

Additional supplementary publications are issued covering *Alcohol and Tobacco Tax Regulations* and *Regulations Under Tax Conventions.*

BLANK PAGE

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953 (Continued)

Normal Taxes and Surtaxes (Continued)

REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

Sec.
1.851-1 Definition of regulated investment company.
1.851-2 Limitations.
1.851-3 Rules applicable to section 851(b)(4).
1.851-4 Determination of status.
1.851-5 Examples.
1.851-6 Investment companies furnishing capital to development corporations.
1.851-7 Certain unit investment trusts.
1.852-1 Taxation of regulated investment companies.
1.852-2 Method of taxation of regulated investment companies.
1.852-3 Investment company taxable income.
1.852-4 Method of taxation of shareholders of regulated investment companies.
1.852-5 Earnings and profits of a regulated investment company.
1.852-6 Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.
1.852-7 Additional information required in returns of shareholders.
1.852-8 Information returns.
1.852-9 Special procedural requirements applicable to designation under section 852(b)(3)(D).
1.852-10 Distributions in redemption of interests in unit investment trusts.
1.853-1 Foreign tax credit allowed to shareholders.
1.853-2 Effect of election.
1.853-3 Notice to shareholders.
1.853-4 Manner of making election.
1.854-1 Limitations applicable to dividends received from regulated investment company.
1.854-2 Notice to shareholders.
1.854-3 Definitions.
1.855-1 Dividends paid by regulated investment company after close of taxable year.

REAL ESTATE INVESTMENT TRUSTS

1.856-0 Revenue Act of 1978 amendments not included.
1.856-1 Definition of real estate investment trust.
1.856-2 Limitations.
1.856-3 Definitions.
1.856-4 Rents from real property.
1.856-5 Interest.
1.856-6 Foreclosure property.

Sec.

1.856-7 Certain corporations, etc., that are considered to meet the gross income requirements.
1.856-8 Revocation or termination of election.
1.856-9 Election with respect to property held for sale in a taxable year beginning before October 5, 1976.
1.857-1 Taxation of real estate investment trusts.
1.857-2 Real estate investment trust taxable income and net capital gain.
1.857-3 Net income from foreclosure property.
1.857-4 Tax imposed by reason of the failure to meet certain source-of-income requirements.
1.857-5 Net income and loss from prohibited transactions.
1.857-6 Method of taxation of shareholders of real estate investment trusts.
1.857-7 Earnings and profits of a real estate investment trust.
1.857-8 Records to be kept by a real estate investment trust.
1.857-9 Information required in returns of shareholders.
1.857-10 Information returns.
1.858-1 Dividends paid by a real estate investment trust after close of taxable year.
1.859-1 Deficiency dividends.
1.859-2 Requirements for deficiency dividends.
1.859-3 Interest and additions to tax.
1.859-4 Claim for credit or refund.
1.860-1 Adoption of or change in annual accounting period.

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

1.861-1 Income from sources within the United States.
1.861-2 Interest.
1.861-3 Dividends.
1.861-4 Compensation for labor or personal services.
1.861-5 Rentals and royalties.
1.861-6 Sale of real property.
1.861-7 Sale of personal property.
1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.
1.861-9 Income from certain aircraft or vessels.
1.862-1 Income specifically from sources without the United States.
1.863-1 Allocation of gross income under section 863(a).
1.863-2 Income derived partly from sources within and partly from sources without the United States.
1.863-3 Income from the sale of personal property derived partly from within and partly from without the United States.
1.863-4 Transportation service.
1.863-5 Telegraph and cable services.
1.863-6 Income from sources within a foreign country or possession of the United States.
1.864-1 Meaning of sale, etc.
1.864-2 Trade or business within the United States.
1.864-3 Rules for determining income effectively connected with U.S. business of nonresident aliens or foreign corporations.
1.864-4 U.S. source income effectively connected with U.S. business.
1.864-5 Foreign source income effectively connected with U.S. business.
1.864-6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.
1.864-7 Definition of office or other fixed place of business.

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

Sec.
1.871-1 Classification and manner of taxing alien individuals.
1.871-2 Determining residence of alien individuals.
1.871-3 Residence of alien seamen.
1.871-4 Proof of residence of aliens.
1.871-5 Loss of residence by an alien.
1.871-6 Duty of withholding agent to determine status of alien employees.
1.871-7 Taxation of nonresident alien individuals not engaged in U.S. business.
1.871-8 Taxation of nonresident alien individuals engaged in U.S. business or treated as having effectively connected income.
1.871-9 Nonresident alien students or trainees deemed to be engaged in U.S. business.
1.871-10 Election to treat real property income as effectively connected with U.S. business.
1.871-11 Gains from sale or exchange of patents, copyrights, or similar property.
1.871-12 Determination of tax on treaty income.
1.871-13 Taxation of individuals for taxable year of change of U.S. citizenship or residence.
1.872-1 Gross income of nonresident alien individuals.
1.872-2 Exclusions from gross income of nonresident alien individuals.
1.873 Statutory provisions; deductions.
1.873-1 Deductions allowed nonresident alien individuals.
1.874-1 Allowances of deductions and credits to nonresident alien individuals.
1.875-1 Partnerships.
1.875-2 Beneficiaries of estates or trusts.
1.876-1 Alien residents of Puerto Rico.
1.879-1 Treatment of community income.

FOREIGN CORPORATIONS

1.881-1 Manner of taxing foreign corporations.
1.881-2 Taxation of foreign corporations not engaged in U.S. business.
1.882-1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.
1.882-2 Income of foreign corporations treated as effectively connected with U.S. business.
1.882-3 Gross income of a foreign corporation.
1.882-4 Allowance of deductions to foreign corporations.
1.882-5 Determination of interest deduction.
1.883-1 Exclusions from gross income of foreign corporations.

MISCELLANEOUS PROVISIONS

1.891 Statutory provisions; doubling of rates of tax on citizens and corporations of certain foreign countries.
1.892-1 Income of foreign governments.
1.892-2 Income of international organizations.
1.893-1 Compensation of employees of foreign governments or international organizations.
1.894-1 Income affected by treaty.
1.895-1 Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

INCOME FROM SOURCES WITHOUT THE UNITED STATES

FOREIGN TAX CREDIT

Sec.
1.901-1 Allowance of credit for taxes.
1.901-3 Reduction in amount of foreign taxes on foreign mineral income allowed as a credit.
1.902-1 Credit for domestic corporate shareholder of a foreign corporation.
1.902-2 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.
1.904-1 Limitation on credit for foreign taxes.
1.904-2 Carryback and carryover of unused foreign tax.
1.904-3 Carryback and carryover of unused foreign tax by husband and wife.
1.904-4 Separate limitation for section 904(f) interest.
1.904-5 Separate limitation for section 904(f) dividends.
1.905-1 When credit for taxes may be taken.
1.905-2 Conditions of allowance of credit.
1.905-3 Redetermination of the tax when credit proves incorrect.
1.905-4 Credit for taxes accrued but not paid.
1.905-5 Credit for United Kingdom income taxes paid with respect to royalties.
1.911-1 Individuals qualifying for the exclusion.
1.911-2 Qualifying earned income.
1.911-3 Determination of the maximum excludable amount of qualifying earned income.
1.911-4 Treatment of community income.
1.911-5 Disallowance of deductions and the foreign tax credit.
1.911-6 Procedural rules.
1.911-7 Effective date of §§ 1.911-1 through 1.911-6.
1.913-1 Deduction for certain expenses of living abroad.
1.913-2 Taxpayers qualifying for the deduction.
1.913-3 Gener[illegible] [illegible]tions.
1.913-4 Foreign sou[illegible] arned income limitation.
1.913-5 Cost-of-living [illegible]erential.
1.913-6 Qualified housing expenses.
1.913-7 Qualified school expenses.
1.913-8 Qualified home leave transportation expenses.
1.913-9 Hardship area amount.
1.913-10 Married couples with two qualifying expenses.
1.913-11 Married couples with community income.
1.913-12 Returns and extensions.
1.913-13 Effective date.

EARNED INCOME OF CITIZENS OF UNITED STATES

1.912-1 Exclusion of certain cost-of-living allowances.
1.912-2 Exclusion of certain allowances of Foreign Service personnel.

WESTERN HEMISPHERE TRADE CORPORATIONS

1.921-1 Definition of Western Hemisphere trade corporation.
1.922-1 Special deduction of Western Hemisphere trade corporation.

POSSESSIONS OF THE UNITED STATES

1.931-1 Citizens of the United States and domestic corporations deriving income from sources within a certain possession of the United States.
1.932-1 Status of citizens of U.S. possessions.
1.933-1 Exclusion of certain income from sources within Puerto Rico.
1.934-1 Limitation on reduction in income tax liability incurred to the Virgin Islands.

Sec.
1.935-1 Coordination of U.S. and Guam individual income taxes.
1.936-1 Elections.

CHINA TRADE ACT CORPORATIONS

1.941-1 Special deduction for China Trade Act corporations.
1.941-2 Meaning of terms used in connection with China Trade Act corporations.
1.941-3 Illustration of principles.
1.943-1 Withholding by a China Trade Act corporation.

CONTROLLED FOREIGN CORPORATIONS

1.951-1 Amounts included in gross income of United States shareholders.
1.951-2 Coordination of subpart F with election of a foreign investment company to distribute income.
1.951-3 Coordination of subpart F with foreign personal holding company provisions.
1.952-1 Subpart F income defined.
1.952-2 Determination of gross income and taxable income of a foreign corporation.
1.953-1 Income from insurance of United States risks.
1.953-2 Actual United States risks.
1.953-3 Risks deemed to be United States risks.
1.953-4 Taxable income to which section 953 applies.
1.953-5 Corporations not qualifying as insurance companies.
1.953-6 Relationship of sections 953 and 954.
1.954-1 Foreign base company income.
1.954-2 Foreign personal holding company income.
1.954-3 Foreign base company sales income.
1.954-4 Foreign base company services income.
1.954-5 Increase in qualified investments in less developed countries.
1.955-1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in less developed countries.
1.955-2 Amount of a controlled foreign corporation's qualified investments in less developed countries.
1.955-3 Election as to date of determining qualified investments in less developed countries.
1.955-4 Definition of less developed country.
1.955-5 Definition of less developed country corporation.
1.955-6 Gross income from sources within less developed countries.
1.956-1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.
1.956-2 Definition of United States property.
1.957-1 Definition of controlled foreign corporation.
1.957-2 Controlled foreign corporation deriving income from insurance of United States risks.
1.957-3 Corporations organized in United States possessions.
1.957-4 United States person defined.
1.958-1 Direct and indirect ownership of stock.
1.958-2 Constructive ownership of stock.
1.959-1 Exclusion from gross income of United States persons of previously taxed earning and profits.
1.959-2 Exclusion from gross income of controlled foreign corporations of previously taxed earnings and profits.
1.959-3 Allocation of distributions to earnings and profits of foreign corporations.
1.959-4 Distributions to United States persons not counting as dividends.
1.960-1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

Sec.
1.960-2 Interrelation of section 902 and section 960 when dividends are paid by second-tier corporation or by first-tier corporation.
1.960-3 Gross-up of amounts included in income under section 951.
1.960-4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.
1.960-5 Credit for taxable year of inclusion binding for taxable year of exclusion.
1.960-6 Overpayments resulting from increase in limitation for taxable year of exclusion.
1.960-7 Effective dates.
1.961-1 Increase in basis of stock in controlled foreign corporations and of other property.
1.961-2 Reduction in basis of stock in foreign corporations and of other property.
1.962-1 Limitation of tax for individuals on amounts included in gross income under section 951(a).
1.962-2 Election of limitation of tax for individuals.
1.962-3 Treatment of actual distributions.
1.962-4 Transitional rules for certain taxable years.
1.963-0 Repeal of section 963; effective dates.
1.963-1 Exclusion of subpart F income upon receipt of minimum distribution.
1.963-2 Determination of the amount of the minimum distribution.
1.963-3 Distributions counting toward a minimum distribution.
1.963-4 Limitations on minimum distribution from a chain or group.
1.963-5 Foreign corporations with variation in foreign tax rate because of distributions.
1.963-6 Deficiency distribution.
1.963-7 Transitional rules for certain taxable years.
1.963-8 Determination of minimum distribution during the surcharge period.
1.964-1 Determination of the earnings and profits of a foreign corporation.
1.964-2 Treatment of blocked earnings and profits.
1.964-3 Records to be provided by United States shareholders.
1.964-4 Verification of certain classes of income.
1.964-5 Effective date of subpart F.

EXPORT TRADE CORPORATIONS

1.970-1 Export trade corporations.
1.970-2 Elections as to date of determining investments in export trade assets.
1.970-3 Effective date of subpart G.
1.971-1 Definitions with respect to export trade corporations.
1.972-1 Consolidation of group of export trade corporations.
1.981-0 Repeal of section 981; effective dates.
1.981-1 Foreign law community income for taxable years beginning after December 31, 1966, and before January 1, 1977.
1.981-2 Foreign law community income for taxable years beginning before January 1, 1967.
1.981-3 Definitions and other special rules.

DOMESTIC INTERNATIONAL SALES CORPORATIONS

1.991-1 Taxation of a domestic international sales corporation.
1.992-1 Requirements of a DISC.
1.992-2 Election to be treated as a DISC.
1.992-3 Deficiency distributions to meet qualification requirements.
1.992-4 Coordination with personal holding company provisions in case of certain produced film rents.
1.993-1 Definition of qualified export receipts.
1.993-2 Definition of qualified export assets.
1.993-3 Definition of export property.

Sec.
1.993-4 Definition of producer's loans.
1.993-5 Definition of related foreign export corporation.
1.993-6 Definition of gross receipts.
1.993-7 Definition of United States.
1.994-1 Inter-company pricing rules for DISC's.
1.994-2 Marginal costing rules.
1.995-1 Taxation of DISC income to shareholders.
1.995-2 Deemed distributions in qualified years.
1.995-3 Distributions upon disqualification.
1.995-4 Gain on certain dispositions of stock in a DISC.
1.995-5 Foreign investment attributable to producer's loans.
1.996-1 Rules for actual distributions and certain deemed distributions.
1.996-2 Ordering rules for losses.
1.996-3 Divisions of earnings and profits.
1.996-4 Subsequent effect of previous disposition of DISC stock.
1.996-5 Adjustment to basis.
1.996-6 Effectively connected income.
1.996-7 Carryover of DISC tax attributes.
1.996-8 Effect of carryback of capital loss or net operating loss to prior DISC taxable year.
1.997-1 Special rules for subchapter C of the Code.

GAIN OR LOSS ON DISPOSITION OF PROPERTY

DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

1.1001-1 Computation of gain or loss.
1.1001-2 Discharge of liabilities.
1.1002-1 Sales or exchanges.

BASIS RULES OF GENERAL APPLICATION

1.1011-1 Adjusted basis.
1.1011-2 Bargain sale to a charitable organization.
1.1012-1 Basis of property.
1.1012-2 Transfers in part a sale and in part a gift.
1.1013 Statutory provisions; basis of property included in inventory.
1.1013-1 Property included in inventory.
1.1014-1 Basis of property acquired from a decedent.
1.1014-2 Property acquired from a decedent.
1.1014-3 Other basis rules.
1.1014-4 Uniformity of basis; adjustment to basis.
1.1014-5 Gain or loss.
1.1014-6 Special rule for adjustments to basis where property is acquired from a decedent prior to his death.
1.1014-7 Example applying rules of §§ 1.1014-4 through 1.1014-6 to case involving multiple interests.
1.1014-8 Bequest, devise, or inheritance of a remainder interest.
1.1014-9 Special rule with respect to DISC stock.
1.1015-1 Basis of property acquired by gift after December 31, 1920.
1.1015-2 Transfer of property in trust after December 31, 1920.
1.1015-3 Gift or transfer in trust before January 1, 1921.
1.1015-4 Transfers in part a gift and in part a sale.
1.1015-5 Increased basis for gift tax paid.
1.1016-1 Adjustments to basis; scope of section.
1.1016-2 Items properly chargeable to capital account.
1.1016-3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.
1.1016-4 Exhaustion, wear and tear, obsolescence, amortization, and depletion; periods during which income was not subject to tax.

Sec.
1.1016-5 Miscellaneous adjustments to basis.
1.1016-6 Other applicable rules.
1.1016-7 Adjusted basis; cancellation of indebtedness under Bankruptcy Act.
1.1016-8 Adjusted basis; cancellation of indebtedness; special cases.
1.1016-9 Adjusted basis; mutual savings banks, building and loan associations, and cooperative banks.
1.1016-10 Substituted basis.
1.1017-1 Adjusted basis; discharge of indebtedness; general rule.
1.1017-2 Adjusted basis; discharge of indebtedness; special cases.
1.1018-1 Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.
1.1019-1 Property on which lessee has made improvements.
1.1020-1 Election as to amounts allowed in respect of depreciation, etc., before 1952.
1.1021-1 Sale of annuities.

COMMON NONTAXABLE EXCHANGES

1.1031(a)-1 Property held for productive use in trade or business or for investment.
1.1031(b)-1 Receipt of other property or money in tax-free exchange.
1.1031(c)-1 Nonrecognition of loss.
1.1031(d)-1 Property acquired upon a tax-free exchange.
1.1031(d)-2 Treatment of assumption of liabilities.
1.1031(e)-1 Exchange of livestock of different sexes.
1.1032-1 Disposition by a corporation of its own capital stock.
1.1033(a)-1 Involuntary conversions; nonrecognition of gain.
1.1033(a)-2 Involuntary conversion into similar property, into money or into dissimilar property.
1.1033(a)-3 Involuntary conversion of principal residence.
1.1033(b)-1 Basis of property acquired as a result of an involuntary conversion.
1.1033(c)-1 Disposition of excess property within irrigation project deemed to be involuntary conversion.
1.1033(d)-1 Destruction or disposition of livestock because of disease.
1.1033(e)-1 Sale or exchange of livestock solely on account of drought.
1.1033(g)-1 Condemnation of real property held for productive use in trade or business or for investment.
1.1033(h)-1 Effective date.
1.1034-1 Sale or exchange of residence.
1.1035-1 Certain exchanges of insurance policies.
1.1036-1 Stock for stock of the same corporation.
1.1037-1 Certain exchanges of United States obligations.
1.1038-1 Reacquisitions of real property in satisfaction of indebtedness.
1.1038-2 Reacquisition and resale of property used as a principal residence.
1.1038-3 Election to have section 1038 apply for taxable years beginning after December 31, 1957.
1.1039-1 Certain sales of low-income housing projects.

SPECIAL RULES

1.1051-1 Basis of property acquired during affiliation.
1.1052-1 Basis of property established by Revenue Act of 1932.
1.1052-2 Basis of property established by Revenue Act of 1934.

Sec.
1.1052-3 Basis of property established by the Internal Revenue Code of 1939.
1.1053-1 Property acquired before March 1, 1913.
1.1054-1 Certain stock of Federal National Mortgage Association.
1.1055-1 General rule with respect to redeemable ground rents.
1.1055-2 Determination of amount realized on the transfer of the right to hold real property subject to liabilities under a redeemable ground rent.
1.1055-3 Basis of real property held subject to liabilities under a redeemable ground rent.
1.1055-4 Basis of redeemable ground rent reserved or created in connection with transfers of real property before April 11, 1963.

CHANGES TO EFFECTUATE F.C.C. POLICY

1.1071-1 Gain from sale or exchange to effectuate policies of Federal Communications Commission.
1.1071-2 Nature and effect of election.
1.1071-3 Reduction of basis of property pursuant to election under section 1071.
1.1071-4 Manner of election.

EXCHANGES IN OBEDIENCE TO S.E.C. ORDERS

1.1081-1 Terms used.
1.1081-2 Purpose and scope of exception.
1.1081-3 Exchanges of stock or securities solely for stock or securities.
1.1081-4 Exchanges of property for property by corporations.
1.1081-5 Distribution solely of stock or securities.
1.1081-6 Transfers within system group.
1.1081-7 Sale of stock or securities received upon exchange by members of system group.
1.1081-8 Exchanges in which money or other nonexempt property is received.
1.1081-9 Requirements with respect to order of Securities and Exchange Commission.
1.1081-10 Nonapplication of other provisions of the Internal Revenue Code of 1954.
1.1081-11 Records to be kept and information to be filed with returns.
1.1082-1 Basis for determining gain or loss.
1.1082-2 Basis of property acquired upon exchanges under section 1081 (a) or (e).
1.1082-3 Reduction of basis of property by reason of gain not recognized under section 1081(b).
1.1082-4 Basis of property acquired by corporation under section 1081(a), 1081(b), or 1081(e) as contribution of capital or suplus, or in consideration for its own stock or securities.
1.1082-5 Basis of property acquired by shareholder upon tax-free distribution under section 1081(c) (1) or (2).
1.1082-6 Basis of property acquired under section 1081(d) in transactions between corporations of the same system group.
1.1083-1 Definitions.

WASH SALES OF STOCK OR SECURITIES

1.1091-1 Losses from wash sales of stock or securities.
1.1091-2 Basis of stock or securities acquired in "wash sales".

DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT OF 1956

Sec.
1.1101-1 In general.
1.1101-2 Certification by Board.
1.1101-3 Tax avoidance.
1.1101-4 Records to be kept and information to be filed with returns.
1.1102-1 Basis of property acquired in distributions by qualified bank holding corporations.
1.1102-2 Filing of notification under section 1102(b) by qualified bank holding corporations.
1.1102-3 Allocation of earnings and profits in certain distributions by qualified bank holding corporations.

AUTHORITY: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805, unless otherwise noted.

SOURCE: Treasury Decision 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

§ 1.851-1 Definition of regulated investment company.

(a) *In general.* The term "regulated investment company" is defined to mean any domestic corporation (other than a personal holding company as defined in section 542) which meets (1) the requirements of section 851(a) and paragraph (b) of this section, and (2) the limitations of section 851(b) and § 1.851-2. As to the definition of the term "corporation", see section 7701(a)(3).

(b) *Requirement.* To qualify as a regulated investment company, a corporation must be:

(1) Registered at all times during the taxable year, under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company or a unit investment trust, or

(2) A common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) from the definition of "investment company" and not included in the definition of "common trust fund" by section 584(a).

§ 1.851-2 Limitations.

(a) *Election to be a regulated investment company.* Under the provisions of section 851(b)(1), a corporation, even though it satisfies the other requirements of part I, subchapter M, chapter 1 of the Code, for the taxable year, will not be considered a regulated investment company for such year, within the meaning of such part I, unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year which began after December 31, 1941. The election shall be made by the taxpayer by computing taxable income as a regulated investment company in its return for the first taxable year for which the election is applicable. No other method of making such election is permitted. An election once made is irrevocable for such taxable year and all succeeding taxable years.

(b) *Gross income requirement*—(1) *General rule.* Section 851(b) (2) and (3) provides that (i) at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and (ii) less than 30 percent of its gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. In determining the gross income requirements under section 851(b) (2) and (3), a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 1223 insofar as applicable.

(2) *Special rules.* (i) For purposes of section 851(b)(2), there shall be treated as dividends amounts which are included in gross income for the taxable year under section 951(a)(1)(A)(i) to the extent that (*a*) a distribution out of a foreign corporation's earnings and profits of the taxable year is not included in gross income by reason of section 959 (a)(1), and (*b*) the earnings and profits are attributable to the amounts which were so included in gross income under section 951(a)(1)(A)(i). For allocation of distributions to earnings and profits of foreign corporations, see § 1.959-3. The provisions of this subparagraph shall apply with respect to taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (within the meaning of section 951(b) within which or with which such taxable years of such controlled foreign corporations end.

(ii) For purposes of subdivision (i) of this subparagraph, if by reason of section 959(a)(1) a distribution of a foreign corporation's earnings and profits for a taxable year described in section 959(c)(2) is not included in a shareholder's gross income, then such distribution shall be allocated proportionately between amounts attributable to amounts included under each clause of section 951(a)(1)(A). Thus, for example, M is a United States shareholder in X Corporation, a controlled foreign corporation. M and X each use the calendar year as the taxable year. For 1977, M is required by section 951(a)(1)(a) to include $3,000 in its gross income, $1,000 of which is included under clause (i) thereof. In 1977, M received a distribution described in section 959(c)(2) of $2,700 out of X's earnings and profits for 1977, which is, by reason of section 959(a)(1), excluded from M's gross income. The amount of the distribution attributable to the amount included under section 951(a)(1)(A)(i) is $900, i.e., $2,700 multiplied by ($1,000/$3,000).

(c) *Diversification of investments.* (1) Subparagraph (A) of section 851(b)(4) requires that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the taxpayer corporation be represented by one or more of the following:

(i) Cash and cash items, including receivables;

(ii) Government securities;

(iii) Securities of other regulated investment companies; or

(iv) Securities (other than those described in subdivisions (ii) and (iii) of this subparagraph) of any one or more issuers which meet the following limitations: (*a*) The entire amount of the securities of the issuer owned by the taxpayer corporation is not greater in value than 5 percent of the value of the total assets of the taxpayer corporation, and (*b*) the entire amount of the securities of such issuer owned by the taxpayer corporation does not represent more than 10 percent of the outstanding voting securities of such issuer. For the modification of the percentage limitations applicable in the case of certain venture capital investment companies, see section 851(e) and § 1.851-6.

Assuming that at least 50 percent of the value of the total assets of the corporation satisfies the requirements specified in this subparagraph, and that the limiting provisions of subparagraph (B) of section 851(b)(4) and subparagraph (2) of this paragraph are not violated, the corporation will satisfy the requirements of section 851(b)(4), notwithstanding that the remaining assets do not satisfy the diversification requirements of subparagraph (A) of section 851(b)(4). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of subparagraphs (A) and (B) of section 851(b)(4).

(2) Subparagraph (B) of section 851(b)(4) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in subparagraph (A) of section 851(b)(4)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer company controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers as are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4090, Apr. 28, 1962; T.D. 7555, 43 FR 32753, July 28, 1978]

§ 1.851-3 Rules applicable to section 851(b)(4).

In determining the value of the taxpayer's investment in the securities of any one issuer, for the purposes of subparagraph (B) of section 851(b)(4), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. See example (4) in § 1.851-5. For purposes of §§ 1.851-2, 1.851-4, 1.851-5, and 1.851-6, the terms "controls", "controlled group", and "value" have the meaning assigned to them by section 851(c). All other terms used in such sections have the same meaning as when used in the Investment Company Act of 1940 (15 U.S.C., ch. 2D) or that act as amended.

§ 1.851-4 Determination of status.

With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 851(b)(4) and paragraph (c) of § 1.851-2, or the effect that the elimination of such discrepancies will have on the status of a company as a regulated investment company for purposes of part I, subchapter M, chapter 1 of the Code, see section 851(d). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 851 during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

[T.D. 6598, 27 FR 4090, Apr. 28, 1962]

§ 1.851-5 Examples.

The provisions of section 851 may be illustrated by the following examples:

Example (1). Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows:

	Percent
Cash	5
Government securities	10
Securities of regulated investment companies	20
Securities of Corporation A	10
Securities of Corporation B	15
Securities of Corporation C	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	20
Total	100

Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of the other corporations. None of the corporations is a member of a controlled group. Investment Company W meets the requirements under section 851(b)(4) at the end of its first quarter. It complies with subparagraph (A) of section 851(b)(4) since it has 55 percent of its assets invested as provided in such subparagraph. It complies with subparagraph (B) of section 851(b)(4) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

Example (2). Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash	10
Government securities	35
Securities of Corporation A	7
Securities of Corporation B	12
Securities of Corporation C	15
Securities of Corporation D	21
Total	100

Investment Company V fails to meet the requirements of subparagraph (A) of section 851(b)(4) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example (3). Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	20
Securities of Corporation A	5
Securities of Corporation B	10
Securities of Corporation C	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	40
Total	100

Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851(b)(4) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example (4). Investment Company Y at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	15
Securities of Corporation K (a regulated investment company)	30

	Percent
Securities of Corporation A	10
Securities of Corporation B	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	25
Total	100

Corporation K has 20 percent of its assets invested in Corporation L and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation L. Investment Company Y is disqualified under subparagraph (B) of section 851(b)(4) since more than 25 percent of its assets are considered invested in Corporation B as shown by the following calculation:

	Percent
Percentage of assets invested directly in Corporation B	20.0
Percentage invested through the controlled group, Y-K-L-B (40 percent of 20 percent of 30 percent)	2.4
Percentage invested in the controlled group, Y-A-B (30 percent of 10 percent)	3.0
Total percentage of assets of investment Company Y invested in Corporation B	25.4

Example (5). Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 1955 meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 1955 because of such distributions, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such distributions.

Example (6). Investment Company Q, which keeps its books and makes its returns on the basis of a calendar year, at the close of the first quarter of 1955, meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 1955, it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Corporation Q does not lose its status as a regulated investment company for the taxable year 1955 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such market value fluctuations.

§ 1.851-6 Investment companies furnishing capital to development corporations.

(a) *Qualifying requirements.* (1) In the case of a regulated investment company which furnishes capital to development corporations, section 851(e) provides an exception to the rule relating to the diversification of investments, made applicable to regulated investment companies by section 851(b)(4)(A). This exception (as provided in paragraph (b) of this section) is available only to registered management investment companies which the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate, not earlier than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

(2) For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company

whose securities it holds if within 10 years before such date it had acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(b) *Exception to general rule.* (1) The registered management investment company, which for the taxable year meets the requirements of paragraph (a) of this section, may (subject to the limitations of section 851(e)(2) and paragraph (c) of this section) in the computation of 50 percent of the value of its assets under section 851(b)(4)(A) and paragraph (c)(1) of § 1.851-2 for any quarter of such taxable year, include the value of any securities of an issuer (whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisition of any securities of such issuer the basis of all such securities in the hands of the investment company does not exceed 5 percent of the value of the total assets of the investment company at that time. The exception provided by section 851(e)(1) and this subparagraph is not applicable to the securities of an issuer if the investment company has continuously held any security of such issuer or of any predecessor company (as defined in paragraph (d) of this section) for 10 or more years preceding such quarter of the taxable year. The rule of section 851(e)(1) with respect to the relationship of the basis of the securities of an issuer to the value of the total assets of the investment company is, in substance, a qualification of the 5-percent limitation in section 851(b)(4)(A)(ii) and paragraph (c)(1)(iv) of § 1.851-2. All other provisions and requirements of section 851 and §§ 1.851-1 through 1.851-6 are applicable in determining whether such registered management investment company qualifies as a regulated investment company.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) The XYZ Corporation, a regulated investment company, qualified under section 851(e) as an investment company furnishing capital to development corporations. On June 30, 1954, the XYZ Corporation purchased 1,000 shares of the stock of the A Corporation at a cost of $30,000. On June 30, 1954, the value of the total assets of the XYZ Corporation was $1,000,000. Its investment in the stock of the A Corporation ($30,000) comprised 3 percent of the value of its total assets, and it therefore met the requirements prescribed by section 851(b)(4)(A)(ii) as modified by section 851(e)(1).

(ii) On June 30, 1955, the value of the total assets of the XYZ Corporation was $1,500,000 and the 1,000 shares of stock of the A Corporation which the XYZ Corporation owned appreciated in value so that they were then worth $60,000. On that date, the XYZ Investment Company increased its investment in the stock of the A Corporation by the purchase of an additional 500 shares of that stock at a total cost of $30,000. The securities of the A Corporation owned by the XYZ Corporation had a value of $90,000 (6 percent of the value of the total assets of the XYZ Corporation) which exceeded the limit provided by section 851(b)(4)(A)(ii). However, the investment of the XYZ Corporation in the A Corporation on June 30, 1955, qualified under section 851(b)(4)(A) as modified by section 851(e)(1), since the basis of those securities to the investment company did not exceed 5 percent of the value of its total assets as of June 30, 1955, illustrated as follows:

Basis to the XYZ Corporation of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 500 shares of the A Corporation's stock acquired by the XYZ Corporation on June 30, 1955	30,000
Basis of all stock of A Corporation	60,000

Basis of stock of A Corporation ($60,000)/ Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000)=4 percent

Example (2). The same facts existed as in example (1), except that on June 30, 1955, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 1,000 shares of that stock (instead of 500 shares) at a total cost of $60,000. No part of the investment of the XYZ Corporation in the A Corporation qualified under the 5 percent limitation provided by section 851(b)(4)(A) as modified by section 851(e)(1), illustrated as follows:

Basis to the XYZ Corporation of the 1,000 shares of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 1,000 shares of the A Corporation's stock acquired on June 30, 1955	60,000
Total	90,000

Basis of stock of A Corporation ($90,000)/ Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000)= 6 percent

Example (*3*). The same facts existed as in example (2) and on June 30, 1956, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 100 shares of that stock at a total cost of $6,000. On June 30, 1956, the value of the total assets of the XYZ Corporation was $2,000,000 and on that date the investment in the A Corporation qualified under section 851(b)(4)(A) as modified by section 851(e)(1) illustrated as follows:

Basis to the XYZ Corporation of investments in the A Corporation's stock:	
1,000 shares acquired June 30, 1954	$30,000
1,000 shares acquired June 30, 1955	60,000
100 shares acquired June 30, 1956	6,000
Total	96,000

Basis of stock of A Corporation ($96,000)/ Value of XYZ Corporation's total assets at June 30, 1956, time of the latest acquisition ($2,000,000)=4.8 percent

(c) *Limitation.* Section 851(e) and this section do not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under subparagraph (A) of section 851(b)(4) and paragraph (c)(1) of § 1.851-2 for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such subparagraph (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which such investment company (1) holds more than 10 percent of the outstanding voting securities of such issuer, and (2) has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(d) *Definition of predecessor company.* As used in section 851(e) and this section, the term "predecessor company" means any corporation the basis of whose securities in the hands of the investment company was, under the provisions of section 358 or corresponding provisions of prior law, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this section have the same meaning as when used in section 851(b)(4). See paragraph (c) of § 1.851-2 and § 1.851-3.

§ 1.851-7 Certain unit investment trusts.

(a) *In general.* For purposes of the Internal Revenue Code, a unit investment trust (as defined in paragraph (d) of this section) shall not be treated as a person (as defined in section 7701(a)(1)) except for years ending before January 1, 1969. A holder of an interest in such a trust will be treated as directly owning the assets of such trust for taxable years of such holder which end with or within any year of the trust to which section 851(f) and this section apply.

(b) *Treatment of unit investment trust.* A unit investment trust shall not be treated as an individual, a trust estate, partnership, association, company, or corporation for purposes of the Internal Revenue Code. Accordingly, a unit investment trust is not a taxpayer subject to taxation under the Internal Revenue Code. No gain or loss will be recognized by the unit investment trust if such trust distributes a holder's proportionate share of the trust assets in exchange for his interest in the trust. Also, no gain or loss will be recognized by the unit investment trust if such trust sells the holder's proportionate share of the trust assets and distributes the proceeds from such share to the holder in exchange for his interest in the trust.

(c) *Treatment of holder of interest in unit investment trust.* (1) Each holder of an interest in a unit investment trust shall be treated (to the extent of such interest) as owning a proportionate share of the assets of the trust. Accordingly, if the trust distributes to the holder of an interest in such trust his proportionate share of the trust assets in exchange for his interest in the trust, no gain or loss shall be recognized by such holder (or by any other holder of an interest in such trust). For purposes of this paragraph, each purchase of an interest in the trust by the holder will be considered a separate interest in the trust. Items of income, gain, loss, deduction, or credit received by the trust or a custodian thereof shall be taxed to the holders of interests in the trust (and not to the trust) as though they had received their proportionate share of the items directly on the date such items were received by the trust or custodian.

(2) The basis of the assets of such trust which are treated under subparagraph (1) of this paragraph as being owned by the holder of an interest in such trust shall be the same as the basis of his interest in such trust. Accordingly, the amount of the gain or loss recognized by the holder upon the sale by the unit investment trust of the holder's pro rata share of the trust assets shall be determined with reference the basis, of his interest in the trust. Also, the basis of the assets received by the holder, if the trust distributes a holder's pro rata share of the trust assets in exchange for his interest in the trust, will be the same as the basis of his interest in the trust. If the unit investment trust sells less than all of the holder's pro rata share of the trust assets and the holder retains an interest in the trust, the amount of the gain or loss recognized by the holder upon the sale shall be determined with reference to the basis of his interest in the assets sold by the trust, and the basis of his interest in the trust shall be reduced accordingly. If the trust distributes a portion of the holder's pro rata share of the trust assets in exchange for a portion of his interest in the trust, the basis of the assets received by the holder shall be determined with reference to the basis of his interest in the assets distributed by the trust, and the basis of his interest in the trust shall be reduced accordingly. For purposes of this subparagraph the basis of the holder's interest in assets sold by the trust or distributed to him shall be an amount which bears the same relationship to the basis of his total interest in the trust that the fair market value of the assets so sold or distributed bears to the fair market value of such total interest in the trust, such fair market value to be determined on the date of such sale or distribution.

(3) The period for which the holder of an interest in such trust has held the assets of the trust which are treated under subparagraph (1) of this paragraph as being owned by him is the same as the period for which such holder has held his interest in such trust. Accordingly, the character of the gain, loss, deduction, or credit recognized by the holder upon the sale by the unit investment trust of the holder's proportionate share of the trust assets shall be determined with reference to the period for which he has held his interest in the trust. Also, the holding period of the assets received by the holder if the trust distributes the holder's proportionate share of the trust assets in exchange for his interest in the trust will include the period for which the holder has held his interest in the trust.

(4) The application of the provisions of this paragraph may be illustrated by the following example:

Example. B entered a periodic payment plan of a unit investment trust (as defined in paragraph (d) of this section) with X Bank as custodian and Z as plan sponsor. Under this plan, upon B's demand, X must either redeem B's interest at a price substantially equal to the fair market value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust, or at B's option distribute such shares of Y to B. B's plan provides for quarterly payments of $1,000. On October 1, 1969, B made his initial quarterly payment of $1,000 and X credited B's account with 110 shares of Y. On December 1, 1969, Y declared and paid a dividend of 25 cents per share, 5 cents of which was designated as a capital gain dividend pursuant to section 852(b)(3) and § 1.852-4. X credited B's account with $27.50 but did not distribute the money to B in 1969. On December 31, 1969, X charged B's account with $1 for custodial fees for calendar year 1969. On January 1, 1970, B paid X $1,000 and X credited B's account with 105 shares of Y. On April 1, 1970, B paid X $1,000 and X credited B's account with 100 shares of Y. B must include in his tax return for 1969 a dividend of $22 and a long-term capital gain of $5.50. In addition, B is entitled to deduct the annual custodial fee of $1 under section 212 of the Code.

(a) On April 4, 1970, at B's request, X sells the shares of Y credited to B's account (315 shares) for $10 per share and distributes the proceeds ($3,150) to B together with the remaining balance of $26.50 in B's account. The receipt of the $26.50 does not result in any tax consequences to B. B recognizes a long-term capital gain of $100 and a short-term capital gain of $50, computed as follows:

(1) B is treated as owning 110 shares of Y as of October 1, 1969. The basis of these shares is $1,000, and they were sold for $1,100 (110 shares at $10 per share). Therefore, B recognizes a gain from the sale or exchange of a capital asset held for more than 6 months in the amount of $100.

(2) B is treated as owning 105 shares of Y as of January 1, 1970, and 100 shares as of April 1, 1970. With respect to the shares acquired on April 1, 1970, there is no gain recognized as the shares were sold for $1,000, which is B's basis of the shares. The shares acquired on January 1, 1970, were sold for $1,050 (105 shares at $10 per share), and B's basis of these shares is $1,000. Therefore, B recognizes a gain of $50 from the sale or exchange of a capital asset held for not more than 6 months.

(b) On April 4, 1970, at B's request, X distributes to B the shares of Y credited to his account and $26.50 in cash. The receipt of the $26.50 does not result in any tax consequences to B. B does not recognize gain or loss on the distribution of the shares of Y to him. The bases and holding periods of B's interests in Y are as follows:

Number of shares	Date acquired	Basis
110	10-1-69	$9.09
105	1-1-70	9.52
100	4-1-70	10.00

(d) *Definition.* A unit investment trust to which this section refers is a business arrangement (other than a segregated asset account, whether or not it holds assets pursuant to a variable annuity contract, under the insurance laws or regulations of a State) which (except for taxable years ending before Jan. 1, 1969)—

(1) Is a unit investment trust (as defined in the Investment Company Act of 1940);

(2) Is registered under such Act;

(3) Issues periodic payment plan certificates (as defined in such Act) in one or more series;

(4) Possesses, as substantially all of its assets, as to all such series, securities issued by—

(i) A single management company (as defined in such Act), and securities acquired pursuant to subparagraph (5) of this paragraph, or

(ii) A single other corporation; and

(5) Has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(e) *Investment in two single management companies.* (1) A unit investment trust may possess securities issued by two or more separate single management companies (as defined in such Act) if—

(i) The trust issues a separate series of periodic payment plan certificates (as defined in such Act) with respect to the securities of each separate single management company which it possesses; and

(ii) None of the periodic payment plan certificates issued by the trust permits joint acquisition of an interest in each series nor the application of payments in whole or in part first to a series issued by one of the single management companies and then to any other series issued by any other single management company.

(2) If a unit investment trust possesses securities of two or more separate single management companies as described in subparagraph (1) of this paragraph and issues a separate series of periodic payment plan certificates with respect to the securities of each such management company, then the holder of an interest in a series shall be treated as the owner of the securities in the single management company represented by such interest.

(i) A holder of an interest in a series of periodic payment plan certificates of a trust who transfers or sells his interest in the series in exchange for an interest in another series of periodic payment plan certificates of the trust shall recognize the gain or loss realized from the transfer or sale as if the trust had sold the shares credited to his interests in the series at fair market value and distributed the proceeds of the sale to him.

(ii) The basis of the interests in the series so acquired by the holder shall be the fair market value of his interests in the series transferred or sold.

(iii) The period for which the holder has held his interest in the series so acquired shall be measured from the date of his acquisition of his interest in that series.

(f) *Cross references.* (1) For reporting requirements imposed on custodians of unit investment trusts described in this section, see §§ 1.852-4, 1.852-9, 1.853-3, 1.854-2, and 1.6042-2.

(2) For rules relating to redemptions of certain unit investment trusts not described in this section, see § 1.852-10.

[T.D. 7187, 37 FR 13254, July 6, 1972, as amended by T.D. 7187, 37 FR 20688, Oct. 3, 1972]

§ 1.852-1 Taxation of regulated investment companies.

(a) *Requirements applicable thereto*—(1) *In general.* Section 852(a) denies the application of the provisions of part I, subchapter M, chapter 1 of the Code (other than section 852(c), relating to earnings and profits), to a regulated investment company for a taxable year beginning after February 28, 1958, unless—

(i) The deduction for dividends paid for such taxable year as defined in section 561 (computed without regard to capital gain dividends) is equal to at least 90 percent of its investment company taxable income for such taxable year (determined without regard to the provisions of section 852(b)(2)(D) and paragraph (d) of § 1.852-3); and

(ii) The company complies for such taxable year with the provisions of § 1.852-6 (relating to records required to be maintained by a regulated investment company).

See section 853(b)(1)(B) and paragraph (a) of § 1.853-2 for amounts to be added to the dividends paid deduction, and section 855 and § 1.855-1, relating to dividends paid after the close of the taxable year.

(2) *Special rule for taxable years of regulated investment companies beginning before March 1, 1958.* The provisions of part I of subchapter M (including section 852(c)) are not applicable to a regulated investment company for a taxable year beginning before March 1, 1958, unless such company meets the requirements of section 852(a) and subparagraph (1) (i) and (ii) of this paragraph.

(b) *Failure to qualify.* If a regulated investment company does not meet the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of this section for the taxable year, it will, even though it may otherwise be classified as a regulated investment company, be taxed in such year as an ordinary corporation and not as a regulated investment company. In such case, none of the provisions of part I of subchapter M (other than section 852(c) in the case of taxable years beginning after February 28, 1958) will be applicable to it. For the rules relating to the applicability of section 852(c), see § 1.852-5.

[T.D. 6598, 27 FR 4091, Apr. 28, 1962]

§ 1.852-2 Method of taxation of regulated investment companies.

(a) *Imposition of normal tax and surtax.* Section 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the investment company taxable income, as defined in section 852(b)(2) and § 1.852-3, for each taxable year of a regulated investment company. The tax is imposed as if the investment company taxable income were the taxable income referred to in section 11. In computing the normal tax under section 11, the regulated investment company's taxable income and the dividends paid deduction (computed without regard to the capital gains dividends) shall both be reduced by the deduction for partially tax-exempt interest provided by section 242.

(b) *Taxation of capital gains*—(1) *In general.* Section 852(b)(3)(A) imposes (i) in the case of a taxable year beginning before January 1, 1970, a tax of 25 percent, or (ii) in the case of a taxable year beginning after December 31, 1969, a tax determined as provided in section 1201(a) and paragraph (a)(3) of § 1.1201-1, on the excess, if any, of the net long-term capital gain of a regulated investment company (subject to tax under part I, subchapter M, chapter 1 of the Code) over the sum of its net short-term capital loss and its deduction for dividends paid (as defined in section 561) determined with reference to capital gain dividends only. For the definition of capital gain dividend paid by a regulated investment company, see section 852(b)(3)(C) and paragraph (c) of § 1.852-4. In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, such deduction for dividends paid shall first be made from the amount subject to tax in accordance with section 1201(a)(1)(B), to the extent thereof, and then from the amount subject to tax in accordance with section 1201(a)(1)(A). See § 1.852-10, relating to certain distributions in redemption of interests in unit investment trusts which, for purposes of the deduction for dividends paid with reference to capital gain dividends only, are not considered preferential dividends under section 562(c). See section 855 and § 1.855-1, relating to dividends paid after the close of the taxable year.

(2) *Undistributed capital gains*—(i) *In general.* A regulated investment company (subject to tax under part I of subchapter M) may, for taxable years beginning after December 31, 1956, designate under section 852(b)(3)(D) an amount of undistributed capital gains to each shareholder of the company. For the definition of the term "undistributed capital gains" and for the treatment of such amounts by a shareholder, see paragraph (b)(2) of § 1.852-4. For the rules relating to the method of making such designation, the returns to be filed, and the payment of the tax in such cases, see paragraph (a) of § 1.852-9.

(ii) *Effect on earnings and profits of a regulated investment company.* If a regulated investment company designates an amount as undistributed capital gains for a taxable year, the earnings and profits of such regulated investment company for such taxable year shall be reduced by the total amount of the undistributed capital gains so designated. In such case, its capital account shall be increased—

(*a*) In the case of a taxable year ending before January 1, 1970, by 75 percent of the total amount designated,

(*b*) In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, by the total amount designated decreased by the amount of tax imposed by section 852(b)(3)(A) with respect to such amount, or

(*c*) In the case of a taxable year beginning after December 31, 1974, by 70 percent of the total amount designated. The earnings and profits of a regulated investment company shall not be reduced by the amount of tax which is imposed by section 852(b)(3)(A) on an amount designated as undistributed capital gains and which is paid by the corporation but deemed paid by the shareholder.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4091, Apr. 28, 1962; T.D. 6921, 32 FR 8754, June 20, 1967; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§ 1.852-3 Investment company taxable income.

Section 852(b)(2) requires certain adjustments to be made to convert taxable income of the investment company to investment company taxable income, as follows:

(a) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(b) The net operating loss deduction provided in section 172 shall not be allowed;

(c) The special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, shall not be allowed. Those not allowed are the deduction for partially tax-exempt interest provided by section 242, the deductions for dividends received provided by sections 243, 244, and 245, and the deduction for certain dividends paid provided by section 247. However, the deduction provided by section 248 (relating to organizational expenditures), otherwise allowable in computing taxable income, shall likewise be allowed in computing the investment company taxable income. See section 852(b)(1) and paragraph (a) of § 1.852-2 for treatment of the deduction for partially tax-exempt interest (provided by section 242) for purposes of computing the normal tax under section 11;

(d) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends (as defined in section 852(b)(3)(C) and paragraph (c) of § 1.852-4); and

(e) The taxable income shall be computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months shall not be placed on an annual basis even though such short taxable year results from a change of accounting period.

§ 1.852-4 Method of taxation of shareholders of regulated investment companies.

(a) *Ordinary income.* (1) Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a regulated investment company shall include such dividends in gross income for the taxable year in which they are received.

(2) See section 853 (b)(2) and (c) and paragraph (b) of § 1.853-2 and § 1.853-3 for the treatment by shareholders of dividends received from a regulated investment company which has made an election under section 853(a) with respect to the foreign tax credit. See section 854 and §§ 1.854-1 through 1.854-3 for limitations applicable to dividends received from regulated investment companies for the purpose of the credit under section 34 (for dividends received on or before December 31, 1964), the exclusion from gross income under section 116, and the deduction under section 243. See section 855 (b) and (d) and paragraphs (c) and (f) of § 1.855-1 for treatment by shareholders of dividends paid by a regulated investment company after the close of the taxable year in the case of an election under section 855(a).

(b) *Capital gains*—(1) *In general.* Under section 852(b)(3)(B), shareholders of a regulated investment company who receive capital gain dividends (as defined in paragraph (c) of this section), in respect of the capital gains of an investment company for a taxable year for which it is taxable under part I, subchapter M, chapter 1 of the Code, as a regulated investment company, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend to which section 1201(d) (1) or (2) applies is the portion so designated by the regulated investment company pursuant to paragraph (c)(2) of this section.

(2) *Undistributed capital gains.* (i) A person who is a shareholder of a regulated investment company at the close of a taxable year of such company for which it is taxable under part I of subchapter M shall include in his gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) any amount of undistributed capital gains. The term "undistributed capital gains" means the amount designated as undistributed capital gains in accordance with paragraph (a) of § 1.852-9, but the amount so designated shall not exceed the shareholder's proportionate part of the amount subject to tax under section 852(b)(3)(A). Such amount shall be included in gross income for the taxable year of the shareholder in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount of such gains designated under paragraph (a) of § 1.852-9 as gain described in section 1201(d) (1) or (2) shall be included in the shareholder's gross income as gain described in section 1201(d) (1) or (2). For certain administrative provisions relating to undistributed capital gains, see § 1.852-9.

(ii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall be deemed to have paid for his taxable year for which such amount is so includible—

(*a*) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, a tax equal to 25 percent of such amount.

(*b*) In the case of a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, a tax equal to the tax designated under paragraph (a)(1) of § 1.852-9 by the regulated investment company as his proportionate share of the capital gains tax paid with respect to such amount, or

(*c*) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, a tax equal to 30 percent of such amount.

Such shareholder is entitled to a credit or refund of the tax so deemed paid in accordance with the rules provided in paragraph (c)(2) of § 1.852-9.

(iii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall increase the adjusted basis of the shares of stock with respect to which such amount is so includible—

(*a*) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, by 75 percent of such amount.

(*b*) In the case of an amount designated with respect to a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, by the amount designated under paragraph (a)(1)(iv) of § 1.852-9 by the regulated investment company, or

(*c*) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, by 70 percent of such amount.

(iv) For purposes of determining whether the purchaser or seller of a share or regulated investment company stock is the shareholder at the close of such company's taxable year who is required to include an amount of undistributed capital gains in gross income, the amount of the undistributed capital gains shall be treated in the same manner as a cash dividend payable to shareholders of record at the close of the company's taxable year. Thus, if a cash dividend paid to shareholders of record as of the close of the regulated investment company's taxable year would be considered income to the purchaser, then the purchaser is also considered to be the shareholder of such company at the close of its taxable year for purposes of including an amount of undistributed capital gains in gross income. If, in such a case, notice on Form 2439 is, pursuant to paragraph (a)(1) of § 1.852-9, mailed by the regulated investment company to the seller, then the seller shall be considered the nominee of the purchaser and, as such, shall be subject to the provisions in paragraph (b) of § 1.852-9. For rules for determining whether a dividend is income to the purchaser or seller of a share of stock, see paragraph (c) of § 1.61-9.

(3) *Partners and partnerships.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a partnership, such amount shall be included in the gross income of the partnership for the taxable year of the partnership in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount so includible by the partnership shall be taken into account by the partners as distributive shares of the partnership gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) pursuant to section 702(a)(2) and paragraph (a)(2) of § 1.702-1. The tax with respect to the undistributed capital gains is deemed paid by the partnership (under section 852(b)(3)(D)(ii) and subparagraph (2)(ii) of this paragraph), and the credit or refund of such tax shall be

taken into account by the partners in accordance with section 702(a)(8) and paragraph (a)(8)(ii) of § 1.702-1 and paragraph (c)(2) of § 1.852-9. In accordance with section 705(a), the partners shall increase the basis of their partnership interests under section 705(a)(1) by the distributive shares of such gains, and shall decrease the basis of their partnership interests by the distributive shares of the amount of the tax under section 705(a)(2)(B) (relating to certain nondeductible expenditures) and paragraph (a)(3) of § 1.705-1.

(4) *Nonresident alien individuals.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a nonresident alien individual, such shareholder shall be treated, for purposes of section 871 and the regulations thereunder, as having realized a long-term capital gain in such amount on the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated.

(5) *Effect on earnings and profits of corporate shareholders of a regulated investment company.* If a shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a corporation, such corporation, in computing its earnings and profits for the taxable year for which such amount is so includible, shall treat such amount as if it had actually been received and the taxes paid shall include any amount of tax liability satisfied by a credit under section 852(b)(3)(D) and subparagraph (2) of this paragraph.

(c) *Definition of capital gain dividend*—(1) *General rule.* A capital gain dividend, as defined in section 852(b)(3)(C), is any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders not later than 45 days (30 days for a taxable year ending before Feb. 26, 1964) after the close of its taxable year. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. For example, a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1955, that of a distribution of $500,000 made December 15, 1955, $200,000 constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, and that such excess was $100,000 instead of $200,000. In such case each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(2) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to subparagraph (1) of this paragraph by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970, to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851-7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the capital gain dividend shown on the notice received by the nominee pursuant to subparagraph (1) of this paragraph. The notice shall include the name and address of the nominee identified as such. This subparagraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice re-

quirements of subparagraph (1) of this paragraph with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and, not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this subparagraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this subparagraph within 30 days of such notice.

(3) *Subsection (d) gain for certain taxable years.* In the case of capital gain dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855), the company must include in its written notice under paragraph (c)(1) of this section a statement showing the shareholder's proportionate share of the capital gain dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d) (1) or (2), the regulated investment company shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains for such year which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the company's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of each capital gain dividend (to which this paragraph applies) which is gain described in section 1201(d) (1) or (2). If, for his taxable year, a shareholder must include in his gross income a capital gain dividend to which this paragraph applies, he shall attach to his income tax return for such taxable year a statement showing, with respect to the total of such dividends for such taxable year received from each regulated investment company, the name and address of the regulated investment company from which such dividends are received, the amount of such dividends, the portion of such dividends which was designated as gain described in section 1201(d)(1), and the portion of such dividends which was designated as gain described in section 1201(d)(2).

(d) *Special treatment of loss on the sale or exchange of regulated investment company stock held less than 31 days*—(1) *In general.* Under section 852(b)(4), if any person, with respect to a share of regulated investment company stock acquired by such person after December 31, 1957, and held for a period of less than 31 days, is required by section 852(b)(3) (B) or (D) to include in gross income as a gain from the sale or exchange of a capital asset held for more than six months—

(i) The amount of a capital gain dividend, or

(ii) An amount of undistributed capital gains,

then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share of stock as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such special treatment with respect to the sale of regulated investment company stock held for a period of less than 31 days is applicable to losses for taxable years ending after December 31, 1957.

(2) *Determination of holding period.* The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 852(b)(4) and this paragraph, a share of regulated investment company stock has been held for a period of less than 31 days. In applying those rules, however, "30 days" shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

(3) *Example.* The application of section 852(b)(4) and this paragraph may be illustrated by the following example:

Example. On December 15, 1958, A purchased a share of stock in the X regulated investment company for $20. The X regulated investment company declared a capital gain dividend of $2 per share to shareholders of record on December 31, 1958. A, therefore, received a capital gain dividend of $2 which, pursuant to section 852(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than 6 months. On January 5, 1959, A sold his share of stock in the X regulated investment company for $17.50, which sale resulted in a loss of $2.50. Under section 852(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than 6 months.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6531, 26 FR 413, Jan. 19, 1961; T.D. 6598, 27 FR 4091, Apr. 28, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7337, 39 FR 44972, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.852-5 Earnings and profits of a regulated investment company.

(a) Any regulated investment company, whether or not such company meets the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of § 1.852-1, shall apply paragraph (b) of this section in computing its earnings and profits for a taxable year beginning after February 28, 1958. However, for a taxable year of a regulated investment company beginning before March 1, 1958, paragraph (b) of this section shall apply only if the regulated investment company meets the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of § 1.852-1.

(b) In the determination of the earnings and profits of a regulated investment company, section 852(c) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a regulated investment company would be $500,000. If the regulated investment company had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the corporation would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year.

§ 1.852-6 Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.

(a) Every regulated investment company shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from the shareholders. The actual owner of stock includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 542, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 544.

(c) Statements setting forth the information (required by paragraph (b) of this section) shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(1) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

When making demand for the written statements required of each shareholder by this paragraph, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by § 1.852-7 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its record required by this section. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by this section shall be taxable as an ordinary corporation and not as a regulated investment company.

§ 1.852-7 Additional information required in returns of shareholders.

Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 1.852-6 requires the company to demand from its shareholders shall submit as a part of his income tax return a statement showing, to the best of his knowledge and belief—

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(d) The names and addresses of the members of his family (as defined in section 544(a)(2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 544 and the regulations thereunder; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

§ 1.852-8 Information returns.

Nothing in §§ 1.852-6 and 1.852-7 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

§ 1.852-9 Special procedural requirements applicable to designation under section 852(b)(3)(D).

(a) *Regulated investment company*—(1) *Notice to shareholders.* (i) A designation of undistributed capital gains under section 852(b)(3)(D) and paragraph (b)(2)(i) of § 1.852-2 shall be made by notice on Form 2439 mailed by the regulated investment company to each person who is a shareholder of record of the company at the close of the company's taxable year. The notice on Form 2439 shall show the name, address, and employer identification number of the regulated investment company; the taxable year of the company for which the designation is made; the name, address, and identifying number of the shareholder; the amount designated by the company for inclusion by the shareholder in computing his long-term capital gains; and the tax paid with respect thereto by the company which is deemed to have been paid by the shareholder.

(ii) In the case of a designation of undistributed capital gains with respect to a taxable year of the regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show the shareholder's proportionate share of such gains which is gain described in section 1201(d)(1), his proportionate share of such gains which is gain described in section 1201(d)(2), and the amount (determined pursuant to subdivision (iv) of this subparagraph) by which the shareholder's adjusted basis in his shares shall be increased.

(iii) In determining under subdivision (ii) of this subparagraph the portion of the undistributed capital gains which, in the hands of the shareholder, is gain described in section 1201(d) (1) or (2), the company shall consider that capital gain dividends for a taxable year are made first from its long-term capital gains for such year which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of undistributed capital gains for a taxable year which is gain described in section 1201(d)(1) is the amount which bears the same ratio to the amount included in his income as designated undistributed capital gains for such year as (*a*) the aggregate amount of the company's gains for such year which are described in section 1201(d)(1) and designated as undistributed capital gains bears to (*b*) the aggregate amount of the company's gains for such year which are designated as undistributed capital gains. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of undistributed capital gains (to which this subdivision applies) which is gain described in section 1201(d) (1) or (2).

(iv) In the case of a designation of undistributed capital gains for any taxable year ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show with respect to the undistributed capital gains of each shareholder the amount by which such shareholder's adjusted basis in his shares shall be increased under section 852(b)(3)(D)(iii). The amount by which each shareholders' adjusted basis in his shares shall be increased is the amount includible in his gross income with respect to such shares under section 852(b)(3)(D)(i) less the tax which the shareholder is deemed to have paid with respect to such shares. The tax which each shareholder is deemed to have paid with respect to such shares is the amount which bears the same ratio to the amount of the tax imposed by section 852(b)(3)(A) for such year with respect to the aggregate amount of the designated undistributed capital gains as the amount of such gains includible in the shareholder's gross income bears to the aggregate amount of such gains so designated.

(v) Form 2439 shall be prepared in triplicate, and copies B and C of the form shall be mailed to the shareholder on or before the 45th day (30th day for a taxable year ending before February 26, 1964) following the close of the company's taxable year. Copy A of each Form 2439 must be associated with the duplicate copy of the undistributed capital gains tax return of the company (Form 2438), as provided in subparagraph (2)(ii) of this paragraph.

(2) *Return of undistributed capital gains tax*—(i) *Form 2438.* Every regulated investment company which designates undistributed capital gains for any taxable year beginning after December 31, 1956, in accordance with subparagraph (1) of this paragraph, shall file for such taxable year an undistributed capital gains tax return on Form 2438 including on such return the total of its undistributed capital gains so designated and the tax with respect thereto. The return on Form 2438 shall be prepared in duplicate and shall set forth fully and clearly the information required to be included therein. The original of Form 2438 shall be filed on or before the 30th day after the close of the company's taxable year with the internal revenue officer designated in instructions applicable to Form 2438. The duplicate copy of form 2438 for the taxable year shall be attached to and filed with the income tax return of the company on Form 1120 for such taxable year.

(ii) *Copies A of Form 2439.* For each taxable year which ends on or before December 31, 1965, there shall be submitted with the company's return on Form 2438 all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. For each taxable year which ends after December 31, 1965, there shall be submitted with the duplicate copy of the company's return on Form 2438, which is attached to and filed with the income tax return of the company on Form 1120 for the taxable year, all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. The copies A of Form 2439 shall be accompanied by lists (preferably in the form of adding machine tapes) of the amounts of undistributed capital gains and of the tax paid with respect thereto shown on such forms. The totals of the listed amounts of undistributed capital gains and of tax paid with respect thereto must agree with the corresponding entries on Form 2438.

(3) *Payment of tax.* The tax required to be returned on Form 2438 shall be paid by the regulated investment company on or before the 30th day after the close of the company's taxable year to the internal revenue officer with whom the return on Form 2438 is filed.

(b) *Shareholder of record not actual owner*—(1) *Notice to actual owner.* In any case in which a notice on Form 2439 is mailed pursuant to paragraph (a)(1) of this section by a regulated investment company to a shareholder of record who is a nominee of the actual owner or owners of the shares of stock to which the notice relates, the nominee shall furnish to each such actual owner notice of the owner's proportionate share of the amounts of undistributed capital gains and tax with respect thereto, as shown on the Form 2439 received by the nominee from the regulated investment company. The nominee's notice to the actual owner shall be prepared in triplicate on Form 2439 and shall contain the information prescribed in paragraph (a)(1) of this section, except that the name and address of the nominee, identified as such, shall be entered on the form in addition to, and in the space provided for, the name and address of the regulated investment company, and the amounts of undistributed capital gains and tax with respect thereto entered on the form shall be the actual owner's proportionate share of the corresponding items shown on the nominee's notice from the regulated investment company. Copies B and C of the Form 2439 prepared by the nominee shall be mailed to the actual owner—

(i) For taxable years of regulated investment companies ending after February 25, 1964, on or before the 75th day (55th day in the case of a nominee who is acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851-7 for taxable years of regulated investment companies ending after December 8, 1970, and 135th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year, or

(ii) For taxable years of regulated investment companies ending before February 26, 1964, on or before the 60th day (120th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year.

(2) *Transmittal of Form 2439.* The nominee shall enter the word "Nominee" in the upper right hand corner of copy B of the notice on Form 2439 received by him from the regulated investment company, and on or before the appropriate day specified in subdivision (i) or (ii) of subparagraph (1) of this paragraph shall transmit such copy B, together with all copies A of Form 2439 prepared by him pursuant to subparagraph (1) of this paragraph, to the internal revenue officer with whom his income tax return is required to be filed.

(3) *Custodian of certain unit investment trusts.* The requirements of this paragraph shall not apply to a nominee who is acting as a custodian of the unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851-7 provided that the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by such nominee as custodian and on or before the 45th day following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

(c) *Shareholders*—(1) *Return requirements.* The copy B of the Form 2439 furnished to a shareholder by the regulated investment company or by a nominee, as provided in paragraph (a) or (b), respectively, of this section, shall be attached to the return of income made by the shareholder for his taxable year in which the amount of undistributed capital gains is includible in gross income, as provided in paragraph (b)(2) of § 1.852-4.

(2) *Credit or refund*—(i) *In general.* The amount of the tax paid by the regulated investment company with respect to the undistributed capital gains required under section 852(b)(3)(D) and paragraph (b)(2) of § 1.852-4 to be included by a shareholder in his computation of long-term capital gains for any taxable year is deemed paid by such shareholder under section 852(b)(3)(D)(ii) and such payment constitutes, for purposes of section 6513(a) (relating to time tax considered paid), an advance payment in like amount of the tax imposed under chapter 1 of the Code for such taxable year. In the case of an overpayment of tax within the meaning of section 6401, see section 6402 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) for rules applicable to the treatment of an overpayment of tax and section 6511 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) with respect to the limitations applicable to the credit or refund of an overpayment of tax.

(ii) *Form to be used.* Claim for refund or credit of the tax deemed to have been paid by a shareholder with respect to an amount of undistributed capital gains shall be made on the shareholder's income tax return for the taxable year in which such amount of undistributed capital gains is includable in gross income. In the case of a shareholder which is a partnership, claim shall be made by the partners on their income tax returns for refund or credit of their distributive shares of the tax deemed to have been paid by the partnership. In the case of a shareholder which is exempt from tax under section 501(a) and to which section 511 does not apply for the taxable year, claim for refund of the tax deemed to have been paid by such shareholder on an amount of undistributed capital gains for such year shall be made on Form 843 and copy B of Form 2439 furnished to such shareholder shall be attached to its claim. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see § 301.6402-2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund, and § 301.6402-3 of this chapter, relating to special rules applicable to income tax.

(3) *Records.* The shareholder is required to keep copy C of the Form 2439 furnished for the regulated investment company's taxable years ending after December 31, 1969, and beginning before January 1, 1975, as part of his records to show increases in the adjusted basis of his shares in such company.

(d) *Penalties.* For criminal penalties for willful failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 11710, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7012, 34 FR 7688, May 15, 1969; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7332, 39 FR 44217, Dec. 23, 1974; T.D. 7337, 39 FR 44973, Dec. 30, 1974]

§ 1.852-10 Distributions in redemption of interests in unit investment trusts.

(a) *In general.* In computing that part of the excess of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax, a regulated investment company is allowed under section 852(b)(3)(A)(ii) a deduction for dividends paid (as defined in section 561) determined with reference to capital gains dividends only. Section 561(b) provides that in determining the deduction for dividends paid, the rules provided in section 562 are applicable. Section 562(c) (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro-rata, with no preference to any share of stock as compared with other shares of the same class except to the extent that the former is entitled to such preference.

(b) *Redemption distributions made by unit investment trust*—(1) *In general.* Where a unit investment trust (as defined in paragraph (c) of this section) liquidates part of its portfolio represented by shares in a management company in order to make a distribution to a holder of an interest in the trust in redemption of part or all of such interest, and by so doing, the trust realizes net long-term capital gain, that portion of the distribution by the trust which is equal to the amount of the net long-term capital gain realized by the trust on the liquidation of the shares in the management company will not be considered a preferential dividend under section 562(c). For example, where the entire amount of net long-term capital gain realized by the trust on such a liquidation is distributed to the redeeming interest holder, the trust will be allowed the entire amount of net long-term capital gain so realized in determining the deduction under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only. This paragraph and section 852(d) shall apply only with respect to the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) realized by the trust which is attributable to a redemption by a holder of an interest in such trust. Such dividend may be designated as a capital gain dividend by a written notice to the certificate holder. Such designation should clearly indicate to the holder that the holder's gain or loss on the redemption of the certificate may differ from such designated amount, depending upon the holder's basis for the redeemed certificate, and that the holder's own records are to be used in computing the holder's gain or loss on the redemption of the certificate.

(2) *Example.* The application of the provisions of this paragraph may be illustrated by the following example:

Example. B entered into a periodic payment plan contract with X as custodian and Z as plan sponsor under which he purchased a plan certificate of X. Under this contract, upon B's demand, X must redeem B's certificate at a price substantially equal to the value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust. Except for a small amount of cash which X is holding to satisfy liabilities and to invest for other plan certificate holders, all of the assets held by X in connection with the trust consist of shares in Y. Pursuant to the terms of the periodic payment plan contract, 100 shares of Y are credited to B's account. Both X and Y have elected to be treated as regulated investment companies. On March 1, 1965, B notified X that he wished to have his entire interest in the unit investment trust redeemed. In order to redeem B's interest, X caused Y to redeem 100 shares of Y which X held. At the time of redemption, each share of Y had a value of $15. X then distributed the $1,500 to B. X's basis for each of the Y shares which was redeemed was $10. Therefore, X realized a long-term capital gain of $500 ($5 × 100 shares) which is attributable to the redemption by B of his interest in the trust. Under section 852(d), the $500 capital gain distributed to B will not be considered a preferential dividend. Therefore, X is allowed a deduction of $500 under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only, with the result that X will not pay a capital gains tax with respect to such amount.

(c) *Definition of unit investment trust.* A unit investment trust to which paragraph (a) of this section refers is a business arrangement which—

(1) Is registered under the Investment Company Act of 1940 as a unit investment trust;

(2) Issues periodic payment plan certificates (as defined in such Act);

(3) Possesses, as substantially all of its assets, securities issued by a management company (as defined in such Act);

(4) Qualifies as a regulated investment company under section 851; and

(5) Complies with the requirements provided for by section 852(a).

Paragraph (a) of this section does not apply to a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851-7.

[T.D. 6921, 32 FR 8755, June 20, 1967, as amended by T.D. 7187, 37 FR 13527, July 6, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.853-1 Foreign tax credit allowed to shareholders.

(a) *In general.* Under section 853, a regulated investment company, meeting the requirements set forth in section 853(a) and paragraph (b) of this section, may make an election with respect to the income, war-profits, and excess profits taxes described in section 901(b)(1) which it pays to foreign countries or possessions of the United States during the taxable year, including such taxes as are deemed paid by it under the provisions of any income tax convention to which the United States is a party. If an election is made, the shareholders of the regulated investment company shall apply their proportionate share of such foreign taxes paid, or deemed to have been paid by it pursuant to any income tax convention, as either a credit (under section 901) or as a deduction (under section 164(a)) as provided by section 853(b)(2) and paragraph (b) of § 1.853-2. The election is not applicable with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate stockholders of a foreign corporation for taxes paid by such foreign corporation).

(b) *Requirements.* To qualify for the election provided in section 853(a), a regulated investment company (1) must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations, and (2) must also, for that year, comply with the requirements prescribed in section 852(a) and paragraph (a) of § 1.852-1. The term "value", for purposes of the first requirement, is defined in section 851(c)(4). For the definition of foreign corporation, see section 7701(a).

§ 1.853-2 Effect of election.

(a) *Regulated investment company.* A regulated investment company making a valid election with respect to a taxable year under the provisions of section 853(a) is, for such year, denied both the deduction for foreign taxes provided by section 164(a) and the credit for foreign taxes provided by section 901 with respect to all income, war-profits, and excess profits taxes (described in section 901(b)(1)) which it has paid to any foreign country or possession of the United States. See section 853(b)(1)(A). However, under section 853(b)(1)(B), the regulated investment company is permitted to add the amount of such foreign taxes paid to its dividends paid deduction for that taxable year. See paragraph (a) of § 1.852-1.

(b) *Shareholder.* Under section 853(b)(2), a shareholder of an investment company, which has made the election under section 853, is, in effect, placed in the same position as a person directly owning stock in foreign corporations, in that he must include in his gross income (in addition to taxable dividends actually received) his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164(a) and the credit under section 901. For such purposes he must treat as gross income from a foreign country or possession of the United States (1) his proportionate share of the taxes paid by the regulated investment company to such foreign country or possession and (2) the portion of any dividend paid by the investment company which represents income derived from such sources.

(c) *Dividends paid after the close of the taxable year.* For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as income received from sources within and taxes paid to foreign countries or possessions of the United States, see section 855(d) and paragraph (f) of § 1.855-1.

(d) *Example.* This section may be illustrated as follows:

(1) The X Corporation, a regulated investment company, has total assets, at the close of the taxable year, of $10 million invested as follows:

Domestic corporations		$4,000,000
Foreign corporations in:		
Country A	$3,500,000	
Country B	2,500,000	
		6,000,000
Total assets		10,000,000

(2) The dividend income of X Corporation is received from the following sources:

Domestic corporations		$300,000
Foreign corporations:		
Country A	$250,000	

Country B	$250,000	
		$500,000
Total dividend income		800,000
Operation and management expenses		80,000
Net dividend income		720,000
Taxes withheld by County B on dividends of $250,000 at a rate of 10 percent	25,000	
Taxes withheld by Country B on dividends of $250,000 at a rate of 20 percent	50,000	
Total foreign taxes withheld		75,000
Income available for distribution		645,000

(3) X Corporation has 250,000 shares of common stock outstanding and distributes the entire $645,000 as a dividend of $2.58 per share of stock.

(4) The X Corporation meets the 50 percent requirement of section 851(b)(4) and the requirements of section 852(a). It notifies each shareholder by mail, within the time prescribed by section 853(c), that by reason of the election they are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding), of which $0.20 represents taxes paid to Country B and $0.10 taxes paid to Country A. The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88 per share, $1.80 per share ($450,000 (which represents such part of the net dividend income of $720,000 as the foreign dividend income of $500,000 bears to the total dividend income of $800,000) divided by 250,000 shares) is to be considered as received from foreign sources. Ninety cents is to be considered as received from Country A, and ninety cents from Country B.

§ 1.853-3 Notice to shareholders.

(a) *General rule.* If a regulated investment company makes an election under section 853(a), in the manner provided in § 1.853-4, the investment company is required, under section 853(c), to furnish its shareholders with a written notice mailed not later than 45 days (30 days for taxable years ending before Feb. 26, 1964) after the close of its taxable year. The notice must designate the shareholder's portion of foreign taxes paid to each such country or possession and the portion of the dividend which represents income derived from sources within each such country or possession. For purposes of section 853(b)(2) and paragraph (b) of § 1.853-2, the amount that a shareholder may treat as his proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country or possession of the United States shall not exceed the amounts so designated by the company in such written notice. If, however, the amount designated by the company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within any foreign country or possession, the shareholder is limited to the amount correctly ascertained.

(b) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (b) of § 1.851-7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts of foreign taxes paid to each such country or possession and the holder's proportionate share of the dividend which represents income derived from sources within each country or possession shown on the notice received by the nominee pursuant to paragraph (a) of this section. The notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return for the taxable year is to be filed, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period: *Provided however*, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.853-4 Manner of making election.

(a) *General rule.* A regulated investment company, to make a valid election under section 853, must—

(1) File with Form 1099 and Form 1096 a statement as part of its return which sets forth the following information:

(i) The total amount of income received from sources within foreign countries and possessions of the United States;

(ii) The total amount of income, war profits, or excess profits taxes (described in section 901(b)(1)) paid, or deemed to have been paid under the provisions of any treaty to which the United States is a party, to such foreign countries or possessions;

(iii) The date, form, and contents of the notice to its shareholders;

(iv) The proportionate share of such taxes paid during the taxable year and foreign income received during such year attributable to one share of stock of the regulated investment company; and

(2) File as part of its return for the taxable year a Form 1118 modified so that it becomes a statement in support of the election made by a regulated investment company for taxes paid to a foreign country or a possession of the United States.

(b) *Irrevocability of the election.* The election is applicable only with respect to taxable years subject to the Code, shall be made with respect to all such foreign taxes, and must be made not later than the time prescribed for filing the return (including extensions thereof). Such election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

§ 1.854-1 Limitations applicable to dividends received from regulated investment company.

(a) *In general.* Section 854 provides special limitations applicable to dividends received from a regulated investment company for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporations, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34.

(b) *Capital gain dividend.* Under the provisions of section 854(a) a capital gain dividend as defined in section 852(b)(3) and paragraph (c) of § 1.852-4 shall not be considered a dividend for purposes of the exclusion under section 116, the deduction under section 243, and, in the case of taxable years ending before January 1, 1965, the credit under section 34.

(c) *Rule for dividends other than capital gain dividends.* (1) Section 854(b)(1) limits the amount that may be treated as a dividend (other than a capital gain dividend) by the shareholder of a regulated investment company, for the purposes of the credit, exclusion, and deduction specified in paragraph (b) of this section, where the investment company receives substantial amounts of income (such as interest, etc.) from sources other than dividends from domestic corporations, which dividends qualify for the exclusion under section 116.

(2) Where the "aggregate dividends received" (as defined in section 854(b)(3)(B) and paragraph (b) of § 1.854-3) during the taxable year by a regulated investment company (which meets the requirements of section 852(a) and paragraph (a) of § 1.852-1 for the taxable year during which it paid such dividend) are less than 75 percent of its gross income for such taxable year (as defined in section 854(b)(3)(A) and paragraph (a) of § 1.854-3), only that portion of the dividend paid by the regulated investment company which bears the same ratio to the amount of such dividend paid as the aggregate dividends received by the regulated investment company, during the taxable year, bears to its gross income for such taxable year (computed without regard to gains from the sale or other disposition of stocks or securities) may be treated as a dividend for purposes of such credit, exclusion, and deduction.

(3) Subparagraph (2) of this paragraph may be illustrated by the following example:

Example. The XYZ regulated investment company meets the requirements of section 852(a) for the taxable year and has received income from the following sources:

Capital gains (from the sale of stock or securities)	$100,000
Dividends (from domestic sources other than dividends described in section 116(b))	70,000
Dividend (from foreign corporations)	5,000
Interest	25,000
Total	200,000
Expenses	20,000
Taxable income	180,000

The regulated investment company decides to distribute the entire $180,000. It distributes a capital gain dividend of $100,000 and a dividend of ordinary income of $80,000. The aggregate dividends received by the regulated investment company from domestic corporations ($70,000) is less than 75 percent of its gross income ($100,000) computed without regard to capital gains from sales of securities. Therefore, an apportionment is required. Since $70,000 is 70 percent of $100,000, out of every $1 dividend of ordinary income paid by the regulated investment company only 70 cents would be available for the credit, exclusion, or deduction referred to in section 854(b)(1). The capital gains dividend and the dividend received from foreign corporations are excluded from the computation.

(d) *Dividends received from a regulated investment company during taxable years of shareholders ending after July 31, 1954, and subject to the Internal Revenue Code of 1939.* For the application of section 854 to taxable years of shareholders of a regulated investment company ending after July 31, 1954, and subject to the Internal Revenue Code of 1939, see § 1.34-5 and § 1.116-2.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8756, June 20, 1967]

§ 1.854-2 Notice to shareholders.

(a) *General rule.* Section 854(b)(2) provides that the amount that a shareholder may treat as a dividend for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporation, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34, shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 45 days (30 days for a taxable year ending before Feb. 26, 1964) after the close of the company's taxable year. If, however, the amount so designated by the company in the notice exceeds the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount as correctly ascertained under section 854(b)(1) and paragraph (c) of § 1.854-1.

(b) *Shareholder of record custodian of certain unit investment trusts.* In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851-7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts that may be treated as a dividend for purposes of the exclusion under section 116 for dividends received by individuals and the deduction under section 243 for dividends received by corporations shown on the notice received by the nominee pursuant to paragraph (a) of this section. This notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.854-3 Definitions.

(a) For the purpose of computing the limitation prescribed by section 854(b)(1)(B) and paragraph (c) of § 1.854-1, the term "gross income" does not include gain from the sale or other disposition of stock or securities. However, capital gains arising from the sale or other disposition of capital assets, other than stock or securities, shall not be excluded from gross income for this purpose.

(b) The term "aggregate dividends received" includes only dividends received from domestic corporations other than dividends described in section 116(b) (relating to dividends not eligible for exclusion from gross income). Accordingly, dividends received from foreign corporations will not be included in the computation of "aggregate dividends received". In determining the amount of any dividend for purposes of this section, the rules provided in section 116(c) (relating to certain distributions) shall apply.

§ 1.855-1 Dividends paid by regulated investment company after close of taxable year.

(a) *General rule.* In—

(1) Determining under section 852(a) and paragraph (a) of § 1.852-1 whether the deduction for dividends paid during the taxable year (without regard to capital gain dividends) by a regulated investment company equals or exceeds 90 percent of its investment company taxable income (determined without regard to the provisions of section 852(b)(2)(D)),

(2) Computing its investment company taxable income (under section 852(b)(2) and § 1.852-3), and

(3) Determining the amount of capital gain dividends (as defined in section 852(b)(3) and paragraph (c) of § 1.852-4 paid during the taxable year, any dividend (or portion thereof) declared by the investment company either before or after the close of the taxable year but in any event before the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if the entire amount of such dividend is ac-

tually distributed to the shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) *Election*—(1) *Method of making election.* The election must be made in the return filed by the company for the taxable year. The election shall be made by the taxpayer (the regulated investment company) by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its investment company taxable income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 855(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 852(c) and § 1.852-5) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which an election has been made for a prior year under section 855(a)). The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 855(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(2) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 855(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.* Under section 855(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includible in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(d) *Examples.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). The X Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000. During that year the company distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1955, the company declared a dividend of $37,000 payable to shareholders on March 20, 1955. Such dividend consisted of the first regular quarterly dividend for 1955 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1954 which was not distributed in 1954. On March 15, 1955, the X Company filed its federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1955, as having been paid during the taxable year 1954. Assuming that the X Company actually distributed the entire amount of the dividend of $37,000 on March 20, 1955, an amount equal to $12,000 thereof will be treated for the purposes of section 852(a) as having been paid during the taxable year 1954. Such amount ($12,000) will be considered by the X Company as a distribution out of the earnings and profits for the taxable year 1954, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them.

Example (2). The Y Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000, and for 1955 taxable income (and earnings or profits) of $125,000. On January 1, 1954, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1954 the company distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1955, the company declared a dividend of $65,000 payable to shareholders on March 31, 1955. On March 15, 1955, the Y Company filed its federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1955, as a dividend paid by it during the taxable year 1954. On March 31, 1955, the Y Company distributed the entire amount of the dividend of $65,000 declared on March 5, 1955. The election under section 855(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1954 ($100,000 earnings and profits less $85,000 distributed during 1954). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1955, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Company out of earnings and profits for the taxable year 1955. Assuming that the only other distribution by the Y Company during 1955 was a distribution of $75,000 paid as a dividend on October 31, 1955, the total amount of the distribution of $65,000 paid on March 31, 1955, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Company will treat the amount of $15,000 as a distribution of the earnings or profits of the company for the taxable year 1954, and the remaining $50,000 as a distribution of the earnings or profits for the year 1955. The distribution of $75,000 on October 31, 1955, is, of course, a taxable dividend out of the earnings and profits for the year 1955.

(e) *Notice to shareholders.* Section 855(c) provides that in the case of dividends, with respect to which a regulated investment company has made an election under section 855(a), any notice to shareholders required under subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. Thus, the notice requirements of section 852(b)(3)(C) and paragraph (c) of § 1.852-4 with respect to capital gain dividends, section 853(c) and § 1.853-3 with respect to allowance to shareholder of foreign tax credit, and section 854(b)(2) and § 1.854-2 with respect to the amount of a distribution which may be treated as a dividend, may be satisfied with respect to amounts to which section 855(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. If the notice under section 855(c) relates to an election with respect to any capital gain dividends, such capital gain dividends shall be aggregated by the investment company with the designated capital gain dividends actually paid during the taxable year to which the election applies (not including such dividends with respect to which an election has been made for a prior year under section 855) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the company. See section 852(b)(3)(C) and paragraph (c) of § 1.852-4.

(f) *Foreign tax election.* Section 855(d) provides that in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8757, June 20, 1967]

REAL ESTATE INVESTMENT TRUSTS

§ 1.856-0 Revenue Act of 1978 amendments not included.

The regulations under part II of subchapter M of the Code do not reflect the amendments made by the Revenue Act of 1978.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856 (g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856-1 Definition of real estate investment trust.

(a) *In general.* The term "real estate investment trust" means a corporation, trust, or association which (1) meets the status conditions in section 856(a) and paragraph (b) of this section, and (2) satisfies the gross income and asset diversification requirements under the limitations of section 856(c) and § 1.856-2. (See, however, paragraph (f) of this section, relating to the requirement that, for taxable years beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association).

(b) *Qualifying conditions.* To qualify as a "real estate investment trust", an organization must be one—

(1) Which is managed by one or more trustees or directors,

(2) The beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest,

(3) Which would be taxable as a domestic corporation but for the provisions of part II, subchapter M, chapter 1 of the Code,

(4) Which, in the case of a taxable year beginning before October 5, 1976, does not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business,

(5) Which is neither (i) a financial institution to which section 585, 586, or 593 applies, nor (ii) an insurance company to which subchapter L applies,

(6) The beneficial ownership of which is held by 100 or more persons, and

(7) Which would not be a personal holding company (as defined in section 542) if all of its gross income constituted personal holding company income (as defined in section 543).

(c) *Determination of status.* The conditions described in subparagraphs (1) through (5) of paragraph (b) of this section must be met during the entire taxable year and the condition described in subparagraph (6) of paragraph (b) of this section must exist during at least 335 days of a taxable year of 12 months or during a proportionate part of a taxable year of less than 12 months. The days during which the latter condition must exist need not be consecutive. In determining the minimum number of days during which the condition described in paragraph (b)(6) of this section is required to exist in a taxable year of less than 12 months, fractional days shall be disregarded. For example, in a taxable year of 310 days, the actual number of days prescribed would be $284\frac{38}{73}$ days ($\frac{310}{365}$ of 335). The fractional day is disregarded so that the required condition in such taxable year need exist for only 284 days.

(d) *Rules applicable to status requirements.* For purposes of determining whether an organization meets the conditions and requirements in section 856(a), the following rules shall apply.

(1) *Trustee.* The term "trustee" means a person who holds legal title to the property of the real estate investment trust, and has such rights and powers as will meet the requirement of "centralization of management" under paragraph (c) of § 301.7701-2 of this chapter (Regulations on Procedure and Administration). Thus, the trustee must have continuing exclusive authority over the management of the trust, the conduct of its affairs, and (except as limited by section 856(d)(3) and § 1.856-4) the management and disposition of the trust property. For example, such authority will be considered to exist even though the trust instrument grants to the shareholders any or all of the following rights and powers: To elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee. The existence of a mere fiduciary relationship does not, in itself, make one a trustee for purposes of section 856(a)(1). The trustee will be considered to hold legal title to the property of the trust, for purposes of this subparagraph, whether the title is held in the name of the trust itself, in the name of one or more of the trustees, or in the name of a nominee for the exclusive benefit of the trust.

(2) *Beneficial ownership.* Beneficial ownership shall be evidenced by transferable shares, or by transferable certificates of beneficial interest, and (subject to the provisions of paragraph (c) of this section) must be held by 100 or more persons, determined without reference to any rules of attribution. Provisions in the trust instrument or corporate charter or bylaws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a real estate investment trust will not render the

shares "nontransferable." For purposes of the regulations under part II of subchapter M, the terms "stockholder," "stockholders," "shareholder," and "shareholders" include holders of beneficial interest in a real estate investment trust, the terms "stock," "shares," and "shares of stock" include certificates of beneficial interest, and the term "shares" includes shares of stock.

(3) *Unincorporated organization taxable as a domestic corporation.* The determination of whether an unincorporated organization would be taxable as a domestic corporation, in the absence of the provisions of part II of subchapter M, shall be made in accordance with the provisions of section 7701(a) (3) and (4) and the regulations thereunder and for such purposes an otherwise qualified real estate investment trust is deemed to satisfy the "objective to carry on business" requirement of paragraph (a) of § 301.7701-2 of this chapter. (Regulations on Procedure and Administration).

(4) *Property held for sale to customers.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust may not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the facts and circumstances in each case.

(5) *Personal holding company.* A corporation, trust, or association, even though it may otherwise meet the requirements of part II of subchapter M, will not be a real estate investment trust if, by considering all of its gross income as personal holding company income under section 543, it would be a personal holding company as defined in section 542. Thus, if at any time during the last half of the trust's taxable year more than 50 percent in value of its outstanding stock is owned (directly or indirectly under the provisions of section 544) by or for not more than 5 individuals, the stock ownership requirement in section 542(a)(2) will be met and the trust would be a personal holding company. See § 1.857-8, relating to record requirements for purposes of determining whether the trust is a personal holding company.

(e) *Other rules applicable.* To the extent that other provisions of chapter 1 of the Code are not inconsistent with those under part II of subchapter M there of and the regulations thereunder, such provisions will apply with respect to both the real estate investment trust and its shareholders in the same manner that they would apply to any other organization which would be taxable as a domestic corporation. For example:

(1) Taxable income of a real estate investment trust is computed in the same manner as that of a domestic corporation;

(2) Section 301, relating to distributions of property, applies to distributions by a real estate investment trust in the same manner as it would apply to a domestic corporation;

(3) Sections 302, 303, 304, and 331 are applicable in determining whether distributions by a real estate investment trust are to be treated as in exchange for stock;

(4) Section 305 applies to distributions by a real estate investment trust of its own stock;

(5) Section 311 applies to distributions by a real estate investment trust;

(6) Except as provided in section 857(d), earnings and profits of a real estate investment trust are computed in the same manner as in the case of a domestic corporation;

(7) Section 316, relating to the definition of a dividend, applies to distributions by a real estate investment trust; and

(8) Section 341, relating to collapsible corporations, applies to gain on the sale or exchange of, or a distribution which is in exchange for, stock in a real estate investment trust in the same manner that it would apply to a domestic corporation.

(f) *Unincorporated status required for certain taxable years.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association. Accordingly, in applying the regulations under part II of subchapter M of the Code with respect to such a taxable year, the term "an unincorporated trust or unincorporated association" is to be substituted for the term "a corporation, trust, or association" each place it appears, and the references to "directors" and "corporate charter or bylaws" are to be disregarded.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917, 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4082, Apr. 28, 1962, as amended by T.D. 6928, 32 FR 13221, Sept. 19, 1967; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856-2 Limitations.

(a) *Effective date.* The provisions of part II, subchapter M, chapter 1 of the Code, and the regulations thereunder apply only to taxable years of a real estate investment trust beginning after December 31, 1960.

(b) *Election.* Under the provisions of section 856(c)(1), a trust, even though it satisfies the other requirements of part II of subchapter M for the taxable year, will not be considered a "real estate investment trust" for such year, within the meaning of such part II, unless it elects to be a real estate investment trust for such taxable year, or has made such an election for a previous taxable year which has not been terminated or revoked under section 856(g)(1) or (2). The election shall be made by the trust by computing taxable income as a real estate investment trust in its return for the first taxable year for which it desires the election to apply, even though it may have otherwise qualified as a real estate investment trust for a prior year. No other method of making such election is permitted. An election cannot be revoked with respect to a taxable year beginning before October 5, 1976. Thus, the failure of an organization to be a qualified real estate investment trust for a taxable year beginning before October 5, 1976, does not have the effect of revoking a prior election by the organization to be a real estate investment trust, even though the organization is not taxable under part II of subchapter M for such taxable year. See section 856(g) and § 1.856-8 for rules under which an election may be revoked with respect to taxable years beginning after October 4, 1976.

(c) *Gross income requirements.* Section 856(c) (2), (3), and (4), provides that a corporation, trust, or association is not a "real estate investment trust" for a taxable year unless it meets certain requirements with respect to the sources of its gross income for the taxable year. In determining whether the gross income of a real estate investment trust satisfies the percentage requirements of section 856(c) (2), (3), and (4), the following rules shall apply:

(1) *Gross income.* For purposes of both the numerator and denominator in the computation of the specified percentages, the term "gross income" has the same meaning as that term has under section 61 and the regulations thereunder. Thus, in determining the gross income requirements under section 856(c) (2), (3), and (4), a loss from the sale or other disposition of stock, securities, real property, etc. does not enter into the computation.

(2) *Lapse of options.* Under section 856(c)(6)(C), the term "interests in real property" includes options to acquire land or improvements thereon, and options to acquire leaseholds of land and improvements thereon. However, where a corporation, trust, or association writes an option giving the holder the right to acquire land or improvements thereon, or writes an option giving the holder the right to acquire a leasehold of land or improvements thereon, any income that the corporation, trust, or association recognizes because the option expires unexercised is not considered to be gain from the sale or other disposition of real property (including interests in real property) for purposes of section 856(c) (2)(D) and (3)(C). The rule in the preceding sentence also applies for

purposes of section 856(c)(4)(C) in determining gain from the sale or other disposition of real property for the 30-percent-of-gross-income limitation.

(3) *Commitment fees.* For purposes of section 856(c) (2)(G) and (3)(G), if consideration is received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property, or for an agreement to purchase or lease both real property and other property, an apportionment of the consideration is required. The apportionment of consideration received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property shall be made under the principles of § 1.856-5(c), relating to the apportionment of interest income.

(4) *Holding period of property.* For purposes of the 30-percent limitation of section 856(c)(4), the determination of the period for which property described in such section has been held is governed by the provisions of section 1223 and the regulations thereunder.

(5) *Rents from real property and interest.* See §§ 1.856-4 and 1.856-5 for rules relating to rents from real property and interest.

(d) *Diversification of investment requirements*—(1) *75-percent test.* Section 856(c)(5)(A) requires that at the close of each quarter of the taxable year at least 75 percent of the value of the total assets of the trust be represented by one or more of the following:

(i) Real estate assets;

(ii) Government securities; and

(iii) Cash and cash items (including receivables).

For purposes of this subparagraph the term "receivables" means only those receivables which arise in the ordinary course of the trust's operation and does not include receivables purchased from another person. Subject to the limitations in section 856(c)(5)(B) and subparagraph (2) of this paragraph, the character of the remaining 25 percent (or less) of the value of the total assets is not restricted.

(2) *Limitations on certain securities.* Under section 856(c)(5)(B), not more than 25 percent of the value of the total assets of the trust may be represented by securities other than those described in section 856(c)(5)(A). The ownership of securities under the 25-percent limitation in section 856(c)(5)(B) is further limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and to not more than 10 percent of the outstanding voting securities of such issuer. Thus, if the real estate investment trust meets the 75-percent asset diversification requirement in section 856(c)(5)(A), it will also meet the first test under section 856(c)(5)(B) since it will, of necessity, have not more than 25 percent of its total assets represented by securities other than those described in section 856(c)(5)(A). However, the trust must also meet two additional tests under section 856(c)(5)(B), i.e. it cannot own the securities of any one issuer in an amount (i) greater in value than 5 percent of the value of the trust's total assets, or (ii) representing more than 10 percent of the outstanding voting securities of such issuer.

(3) *Determination of investment status.* The term "total assets" means the gross assets of the trust determined in accordance with generally accepted accounting principles. In order to determine the effect, if any, which an acquisition of any security or other property may have with respect to the status of a trust as a real estate investment trust, section 856(c)(5) requires a revaluation of the trust's assets at the end of the quarter in which such acquisition was made. A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the trust does not, of itself, affect the status of the trust as a real estate investment trust. A change in the nature of "cash items", for example, the prepayment of insurance or taxes, does not constitute the acquisition of "other property" for purposes of this subparagraph. A real estate investment trust shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 856(c)(5) during

the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(4) *Illustrations.* The application of section 856(c)(5) and this paragraph may be illustrated by the following examples:

Example (1). Real Estate Investment Trust M, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of various corporations (not exceeding, with respect to any one issuer, 5 percent of the value of the total assets of the trust nor 10 percent of the outstanding voting securities of such issuer)	24
Total	100

Trust M meets the requirements of section 856(c)(5) for that quarter of its taxable year.

Example (2). Real Estate Investment Trust P, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of Corporation Z	20
Securities of Corporation X	4
Total	100

Trust P meets the requirement of section 856(c)(5)(A) since at least 75 percent of the value of the total assets is represented by cash, Government securities, and real estate assets. However, Trust P does not meet the diversification requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation Z exceeds 5 percent of the value of the trust's total assets.

Example (3). Real Estate Investment Trust G, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	4
Government securities	9
Real estate assets	70
Securities of Corporation S	5
Securities of Corporation L	4
Securities of Corporation U	4
Securities of Corporation M (which equals 25 percent of Corporation M's outstanding voting securities)	4
Total	100

Trust G meets the 75-percent requirement of section 856(c)(5)(A), but does not meet the requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation M exceeds 10 percent of Corporation M's outstanding voting securities.

Example (4). Real Estate Investment Trust R, at the close of the first quarter of its taxable year (i.e. calendar year), is a qualified real estate investment trust and has its assets invested as follows:

Cash	$5,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities of Corporation P	4,000
Securities of Corporation O	5,000
Securities of Corporation U	5,000
Securities of Corporation T	5,000
Total assets	100,000

During the second calendar quarter the stock in Corporation P increases in value to $50,000 while the value of the remaining assets has not changed. If Real Estate Investment Trust R has made no acquisition of stock or other property during such second quarter it will not lose its status as a real estate investment trust merely by reason of the appreciation in the value of P's stock. If, during the third quarter, Trust R acquires stock of Corporation S worth $2,000, such acquisition will necessitate a revaluation of all of the assets of Trust R as follows:

Cash	$3,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	50,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	2,000
Total assets	146,000

Because of the discrepancy between the value of its various investments and the 25-percent limitation in section 856(c)(5), resulting in part from the acquisition of the stock of Corporation S, Trust R, at the end of the third quarter, loses its status as a real estate investment trust. However, if Trust R, within 30 days after the close of such quarter, eliminates the discrepancy so that it meets the 25-percent limitation, the trust will be considered to have met the requirements of section 856(c)(5) at the close of the third quarter, even though the discrepancy between the value of its investment in Corporation P and the 5-percent limitation in section 856(c)(5) (resulting solely from appreciation) may still exist. If instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P, then because of the discrepancy between the value of its investments and both the 5-percent and the 25-percent limitations in section 856(c)(5) resulting in part from this acquisition, trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter both of the discrepancies are eliminated.

Example (5). If, in the previous example, the stock of Corporation P appreciates only to $10,000 during the second quarter and, in the third quarter, Trust R acquires stock of Corporation S worth $1,000, the assets as of the end of the third quarter would be as follows:

Cash	$4,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	10,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	1,000
Total assets	106,000

Because the discrepancy between the value of its investment in Corporation P and the 6-percent limitation in section 856(c)(5) results solely from appreciation, and because there is no discrepancy between the value of its various investments and the 25-percent limitation, Trust R, at the end of the third quarter, does not lose its status as a real estate investment trust. If, instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P worth $1,000, then, because of the discrepancy between the value of its investment in Corporation P and the 5-percent limitation resulting in part from this acquisition, Trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter this discrepancy is eliminated.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001); (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4083, Apr. 28, 1962 as amended by T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856-3 Definitions.

For purposes of the regulations under part II, subchapter M, chapter 1 of the Code, the following definitions shall apply.

(a) *Value.* The term "value" means, with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the real estate investment trust. In the case of securities of other qualified real estate investment trusts, fair value shall not exceed market value or asset value, whichever is higher.

(b) *Real estate assets.* The term "real estate assets" means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and shares in other qualified real estate investment trusts. The term "mortgages on real property" includes deeds of trust on real property.

(c) *Interests in real property.* The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term does not, however, include mineral, oil, or gas royalty interests, as, for example, a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interests in real property" also includes options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(d) *Real property.* The term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

(e) *Securities.* The term "securities" does not include "interests in real property" or "real estate assets" as those terms are defined in section 856 and this section.

(f) *Qualified real estate investment trusts.* The term "qualified real estate investment trust" means a real estate investment trust within the meaning of part II of subchapter M which is taxable under such part as a real estate investment trust. For purposes of the 75-percent requirement in section 856(c)(5)(A), the trust whose stock has been included by another trust as "real estate assets" must be a "qualified real estate investment trust" for its full taxable year in which falls the close of each quarter of the trust's taxable year for which the computation is made. For example, Real Estate Investment Trust Z for its taxable year ending December 31, 1963, holds as "real estate assets" stock in Real Estate Investment Trust Y, which is also on a calendar year. If Trust Y is not a qualified real estate investment trust for its full taxable year ending December 31, 1963, Trust Z may not include the stock of Trust Y as "real estate assets" in computing the 75-percent requirement as of the close of any quarter of its taxable year ending December 31, 1963.

(g) *Partnership interest.* In the case of a real estate investment trust which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership. The character of the various assets in the hands of the partnerhsip and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of section 856. Thus, for example, if the trust owns a 30-percent capital interest in a partnership which owns a piece of rental property the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership. Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the trust will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the real property of the period that the trust was a member of the partnership, whichever is the shorter.

(h) *Net capital gain.* The term "net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071

(68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6598, 27 FR 4084, Apr. 28, 1962, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 7767, 46 FR 11266, Feb. 6, 1981]

§ 1.856-4 Rents from real property.

(a) *In general.* Subject to the exceptions of section 856(d) and paragraph (b) of this section, the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

(b) *Amounts specifically included or excluded*—(1) *Charges for customary services.* For taxable years beginning after October 4, 1976, the term "rents from real property", for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. The service must be furnished through an independent contractor from whom the trust does not derive or receive any income. See paragraph (b)(5) of this section. For taxable years beginning before October 5, 1976, the rules in paragraph (b)(3) of 26 CFR 1.856-4 (revised as of April 1, 1977), relating to the furnishing of services, shall continue to apply.

(2) *Amounts received with respect to certain personal property*—(i) *In general.* In the case of taxable years beginning after October 4, 1976, rent attributable to personal property that is leased under, or in connection with, the lease of real property is treated under section 856(d)(1)(C) as "rents from real property" (and thus qualified for purposes of the income source requirements) if the rent attributable to the personal property is not more than 15 percent of the total rent received or accrued under the lease for the taxable year. If, however, the rent attributable to personal property is greater than 15 percent of the total rent received or accrued under the lease for the taxable year, then the portion of the rent from the lease that is attributable to personal property will not qualify as "rents from real property".

(ii) *Application.* In general, the 15-percent test in section 856(d)(1)(C) is applied separately to each lease of real property. However, where the real estate investment trust rents all (or a portion of all) the units in a multiple unit project under substantially similar leases (such as the leasing of apartments in an apartment building or complex to individual tenants), the 15-percent test may be applied with respect to the aggregate rent received or accrued for the taxable year under the similar leases of the property, by using the average of the trust's aggregate adjusted bases of all of the personal property subject to such leases, and the average of the trust's aggregate adjusted bases of all real and personal property subject to such leases. A lease of a furnished apartment is not considered to be substantially similar to a lease of an unfurnished apartment (including an apartment where the trust provides only personal property, such as major appliances, that is commonly provided by a landlord in connection with the rental of unfurnished living quarters).

(iii) *Taxable years beginning before October 5, 1976.* In the case of taxable years beginning before October 5, 1976, any amount of rent that is attributable to personal property does not qualify as rent from real property.

(3) *Disqualification of rent which depends on income or profits of any person.* Except as provided in paragraph (b)(6)(ii) of this section, no amount received or accrued, directly or indirectly, with respect to any real property (or personal property leased under, or in connection with, real property) qualifies as "rents from real property" where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. However, any amount so accured or received shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). Thus, for example, "rents from real property" would include rents where the lease provides for differing percentages or receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease, in a manner which has the effect of basing the rent on income of profits. See paragraph (b)(6) of this section for rules relating to certain amounts received or accrued by a trust which are considered to be based on the income or profits of a sublessee of the prime tenant. The amount received or accrued as rent for the taxable year which is based on a fixed percentage or percentages of the lessee's receipts or sales reduced by escalation receipts (including those determined under a formula clause) will qualify as "rents from real property". Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent shall be increased to reflect all or a portion of an increase in real estate taxes, property insurance, operating costs of the prime tenant, or similar items customarily included in lease escalation clauses. Where in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of all or a portion of the lessee's income or profits, neither the fixed rental nor the additional amount will qualify as "rents from real property". However, where the amount received or accrued for the taxable year under such an agreement includes only the fixed rental, the determination of which does not depend in whole or in part on the income or profits derived by the lessee, such amount may qualify as "rents from real property". An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property", but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1978, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits. The provisions of this subparagraph may be illustrated by the following example:

Example. A real estate investment trust owns land underlying an office building. On January 1, 1975, the trust leases the land for 50 years to a prime tenant for an annual rental of $100x plus 20 percent of the prime tenant's annual gross receipts from the office building in excess of a fixed base amount of $5,000x and 10 percent of such gross receipts in excess of $10,000x. For this purpose the lease defines gross receipts as all amounts received by the prime tenant from occupancy tenants pursuant to leases of space in the office building reduced by the amount by which real estate taxes, property insurance, and operating costs related to the office building for a particular year exceed the amount of such items for 1974. The exclusion from gross receipts of increases since 1974 in real estate taxes, property insurance, and other expenses relating to the office building reflects the fact that the prime tenant passes on to occupancy tenants by way of a customary lease escalation provision the risk that such expenses might increase during the term of an occupancy lease. The exclusion from gross receipts of these expense escalation items will not cause the rental received by the real estate investment trust from the prime tenant to fail to qualify as "rents from real property" for purposes of section 856(c).

(4) *Disqualification of amounts received from persons owned in whole or in part by the trust.* "Rents from real property" does not include any amount received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, at any time during the taxable year, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person. Any amount received from such person will not qualify as "rents from real property" if such person is a corporation and the trust owns 10 percent or more of the total combined voting power of all classes of its stock entitled to vote or 10 percent or more of the total number of shares of all classes of its outstanding stock, or if such person is not a corporation and the trust owns a 10-percent-or-more interest in its assets or net profits. For example, a trust leases an office building to a tenant for which it receives rent of $100,000 for the taxable year 1962. The lessee of the building subleases space to various subtenants for which it receives gross rent of $500,000 for the year 1962. The trust owns 15 percent of the total assets of an unincorporated subtenant. The rent paid by this subtenant for the taxable year is $50,000. Therefore, $10,000 (50,000/500,000×$100,000) of the rent paid to the trust does not qualify as "rents from real property". Where the real estate investment trust receives, directly or indirectly, any amount of rent from any person in which it owns any proprietary interest, the trust shall submit, at the time it files its return for the taxable year (or before June 1, 1962, whichever is later), a schedule setting forth—

(i) The name and address of such person and the amount received as rent from such person; and

(ii) If such person is a corporation, the highest percentage of the total combined voting power of all classes of its stock entitled to vote, and the highest percentage of the total number of shares of all classes of its outstanding stock, owned by the trust at any time during the trust's taxable year; or

(iii) If such person is not a corporation, the highest percentage of the trust's interest in the assets or net profits of such person, owned by the trust at any time during its taxable year.

(5) *Furnishing of services or management of property must be through an independent contractor*—(i) *In general.* No amount received or accrued, directly or indirectly, with respect to any real property (or any personal property leased under, or in connection with, the real property) qualifies as "rents from real property" if the real estate investment trust furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. The prohibition against the trust deriving or receiving any income from the independent contractor applies regardless of the source from which the income was derived by the independent contractor. Thus, for example, the trust may not receive any dividends from the independent contractor. The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship. The independent contractor must be adequately compensated for any services which are performed for the trust.

Compensation to an independent contractor determined by reference to an unadjusted percentage of gross rents will generally be considered to be adequate where the percentage is reasonable taking into account the going rate of compensation for managing similar property in the same locality, the services rendered, and other relevant factors. The independent contractor must not be an employee of the trust (*i.e.*, the manner in which he carries out his duties as independent contractor must not be subject to the control of the trust). Although the cost of services which are customarily rendered or furnished in connection with the rental of real property may be borne by the trust, the services must be furnished or rendered through an independent contractor. Furthermore, the facilities through which the services are furnished must be maintained and operated by an independent contractor. For example, if a heating plant is located in the building, it must be maintained and operated by an independent contractor. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

(ii) *Trustee or director functions.* The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust.

(iii) *Independent contractor defined.* The term "independent contractor" means—

(*a*) A person who does not own, directly or indirectly, at any time during the trust's taxable year more than 35 percent of the shares in the real estate investment trust, or

(*b*) A person—

(*1*) If a corporation, not more than 35 percent of the total combined voting power of whose stock (or 35 percent of the total shares of all classes of whose stock), or

(*2*) If not a corporation, not more than 35 percent of the interest in whose assets or net profits

is owned, directly or indirectly, at any time during the trust's taxable year by one or more persons owning at any time during such taxable year 35 percent or more of the shares in the trust.

(iv) *Information required.* The real estate investment trust shall submit with its return for the taxable year (or before June 1, 1962, whichever is later) a statement setting forth the name and address of each independent contractor; and

(*a*) The highest percentage of the outstanding shares in the trust owned at any time during its taxable year by such independent contractor and by any person owning at any time during such taxable year any shares of stock or interest in the independent contractor.

(*b*) If the independent contractor is a corporation such statement shall set forth the highest percentage of the total combined voting power of its stock and the highest percentage of the total number of shares of all classes of its stock owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(*c*) If the independent contractor is not a corporation such statement shall set forth the highest percentage of any interest in its assets or net profits owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(6) *Amounts based on income or profits of subtenants.* (i) Except as provided in paragraph (b)(6)(ii) of this section, if a trust leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as "rents from real property".

(ii) *Exception.* For taxable years beginning after October 4, 1976, section 856(d)(4) provides an exception to the general rule that amounts received or accrued, directly or indirectly, by a real estate investment trust do not qualify as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. This exception applies where the trust rents property to a tenant (the prime tenant) for a rental which is based, in whole or in part, on a fixed percentage or percentages of the receipts or sales of the prime tenant, and the rent which the trust receives or accrues from the prime tenant pursuant to the lease would not qualify as "rents from real property" solely because the prime tenant receives or accrues from subtenants (including concessionaires) rents or other amounts based on the income or profits derived by a person from the property. Under the exception, only a proportionate part of the rent received or accrued by the trust does not qualify as "rents from real property". The proportionate part of the rent received or accrued by the trust which is non-qualified is the lesser of the following two amounts:

(A) The rent received or accrued by the trust from the prime tenant pursuant to the lease, that is based on a fixed percentage or percentages of receipts or sales, or

(B) The product determined by multiplying the total rent which the trust receives or accrues from the prime tenant pursuant to the lease by a fraction, the numerator of which is the rent or other amount received by the prime tenant that is based, in whole or in part, on the income or profits derived by any person from the property, and the denominator of which is the total rent or other amount received by the prime tenant from the property. For example, assume that a real estate investment trust owns land underlying a shopping center. The trust rents the land to the owner of the shopping center for an annual rent of $10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants who lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of $100x and, of that amount, $25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property. Accordingly, the trust will receive a total rent of $12x, of which $2x is based on a percentage of the gross receipts of the prime tenant. The portion of the rent which is disqualified is the lesser of $2x (the rent received by the trust which is based on a percentage of gross receipts), or $3x, ($12x multiplied by $25x/$100x). Accordingly, $10x of the rent received by the trust qualifies as "rents from real property" and $2x does not qualify.

(7) *Attribution rules.* Paragraphs (2) and (3) of section 856(d) relate to direct or indirect ownership of stock, assets, or net profits by the persons described therein. For purposes of determining such direct or indirect ownership, the rules prescribed by section 318(a) (for determining the ownership of stock) shall apply except that "10 percent" shall be substituted for "50 percent" in section 318(a) (2)(C) and (3)(C).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e)

(90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4085, Apr. 28, 1962, as amended by T.D. 6969, 33 FR 12000, Aug. 23, 1968; T.D. 7767, 46 FR 11266, Feb. 6, 1981]

§ 1.856-5 Interest.

(a) *In general.* In computing the percentage requirements in section 856(c) (2)(B) and (3)(B), the term "interest" includes only an amount which constitutes compensation for the use or forbearance of money. For example, a fee received or accrued by a lender which is in fact a charge for services performed for a borrower rather than a charge for the use of borrowed money is not includable as interest.

(b) *Where amount depends on income or profits of any person.* Except as provided in paragraph (d) of this section, any amount received or accrued, directly or indirectly, with respect to an obligation is not includable as interest for purposes of section 856(c) (2)(B) and (3)(B) if, under the principles set forth in paragraph (b)(3) and (6)(i) of § 1.856-4, the determination of the amount depends in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation). Thus, for example, if in accordance with a loan agreement an amount is received or accrued by the trust with respect to an obligation which includes both a fixed amount of interest and a percentage of the borrower's income or profits, neither the fixed interest nor the amount based upon the percentage will qualify as interest for purposes of section 856(c) (2)(B) and (3)(B). This paragraph and paragraph (d) of this section apply only to amounts received or accrued in taxable years beginning after October 4, 1976, pursuant to loans made after May 27, 1976. For purposes of the preceding sentence, a loan is considered to be made before May 28, 1976, if it is made pursuant to a binding commitment entered into before May 28, 1976.

(c) *Apportionment of interest*—(1) *In general.* Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of section 856(c)(3). For purposes of the 75-percent requirement, the apportionment shall be made as follows:

(i) If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

(ii) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multipled by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(2) *Loan value.* For purposes of this paragraph, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide

long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the morgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

(3) *Amount of loan.* For purposes of this paragraph, the amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

(d) *Exception.* Section 856(f)(2) provides an exception to the general rule that amounts received, directly or indirectly, with respect to an obligation do not qualify as "interest" where the determination of the amounts depends in whole or in part on the income or profits of any person. The exception applies where the trust receives or accrues, with respect to the obligation of its debtor, an amount that is based in whole or in part on a fixed percentage or percentages of receipts or sales of the debtor, and the amount would not qualify as interest solely because the debtor has receipts or sale proceeds that are based on the income or profits of any person. Under this exception only a proportionate part of the amount received or accrued by the trust fails to qualify as interest for purposes of the percentage-of-income requirements of section 856(c) (2) and (3). The proportionate part of the amount received or accrued by the trust that is non-qualified is the lesser of the following two amounts:

(1) The amount received or accrued by the trust from the debtor with respect to the obligation that is based on a fixed percentage or percentages of receipts or sales, or

(2) The product determined by multiplying by a fraction the total amount received or accrued by the trust from the debtor with respect to the obligation. The numerator of the fraction is the amount of receipts or sales of the debtor that is based, in whole or in part, on the income or profits of any person and the denominator is the total amount of the receipts or sales of the debtor. For purposes of the preceding sentence, the only receipts or sales to be taken into account are those taken into account in determining the payment to the trust pursuant to the loan agreement.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11268, Feb. 6, 1981]

§ 1.856-6 Foreclosure property.

(a) *In general.* Under section 856(e) a real estate investment trust may make an irrevocable election to treat as "foreclosure property" certain real property (including interests in real property), and any personal property incident to the real property, acquired by the trust after December 31, 1973. This section prescribes rules relating to the election, including rules relating to property eligible for the election. This section also prescribes rules relating to extensions of the general two-year period (hereinafter the "grace period") during which property retains its status as foreclosure property, as well as rules relating to early termination of the grace period under section 856(e)(4). The election to treat property as foreclosure property does not alter the character of the income derived therefrom (other than for purposes of section 856(c)(2)(F) and (3)(F)). For example, if foreclosure property is sold, the determination of whether it is property described in section 1221(1) will not be affected by the fact that it is foreclosure property.

(b) *Property eligible for the election*—(1) *Rules relating to acquisitions.* In general, the trust must acquire the property after December 31, 1973, as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of the property (where the trust was the lessor) or on an indebtedness owed to the trust which the property secured. Foreclosure property which secured an indebtedness owed to the trust is acquired for purposes of section 856(e) on the date on which the trust acquires ownership of the property for Federal income tax purposes. Foreclosure property which a trust owned and leased to another is acquired for purposes of section 856(e) on the date on which the trust acquires possession of the property from its lessee. A trust will not be considered to have acquired ownership of property for purposes of section 856(e) where it takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor. A trust may be considered to have acquired ownership of property for purposes of section 856(e) even through legal title to the property is held by another person. For example, where, upon foreclosure of a mortgage held by the trust, legal title to the property is acquired in the name of a nominee for the exclusive benefit of the trust and the trust is the equitable owner of the property, the trust will be considered to have acquired ownership of the property for purposes of section 856(e). Generally, the fact that under local law the mortgagor has a right of redemption after foreclosure is not relevant in determining whether the trust has acquired ownership of the property for purposes of section 856(e). Property is not ineligible for the election solely because the property, in addition to securing an indebtedness owed to the trust, also secures debts owed to other creditors. Property eligible for the election includes a building or other improvement which has been constructed on land owned by the trust and which is acquired by the trust upon default of a lease of the land.

(2) *Personal property.* Personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put. In the case of a hotel, such items as furniture, appliances, linens, china, food, etc. would be examples of incidental personal property. Personal property incident to the real property is eligible for the election even though it is acquired after the real property is acquired or is placed in the building or other improvement in the course of the completion of construction.

(3) *Property with respect to which default is anticipated.* Property is not eligible for the election to be treated as foreclosure property if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the trust with an intent to evict or foreclose, or when the trust knew or had reason to know that default would occur ("improper knowledge"). For purposes of the preceding sentence, a trust will not be considered to have improper knowledge with respect to a particular lease or loan, if the lease or loan was made pursuant to a binding commitment entered into by the trust at a time when it did not have improper knowledge. Moreover, if the trust, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the lease or loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan or lease was entered into with that intent or knowledge.

(c) *Election*—(1) *In general.* (i) An election to treat property as foreclosure property applies to all of the eligible real property acquired in the same taxable year by the trust upon the default (or as a result of the imminence of default) on a particular lease (where the trust is the lessor) or on a particular indebtedness owed to the trust. For example, if a loan made by a trust is secured by two separate tracts of land located in different cities, and in the same taxable year the trust acquires both tracts on foreclosure upon the default (or imminence of default) of the loan, the trust must include both tracts in the election. For a further example, the trust may choose to make a separate election for only one of the tracts if they are acquired in different taxable years or were not security for the same loan. If real property subject to the same election is acquired at different times in the same taxable year, the grace period for a particular property begins when that property is acquired.

(ii) If the trust acquires separate pieces of real property that secure the same indebtedness (or are under the same lease) in different taxable years because the trust delays acquiring one of them until a later taxable year, and the primary purpose for the delay is to include only one of them in an election, then if the trust makes an election for one piece it must also make an election for the other piece. A trust will not be considered to have delayed the acquisition of property for this purpose if there is a legitimate business reason for the delay (such as an attempt to avoid foreclosure by further negotiations with the debtor or lessee).

(iii) All of the eligible personal property incident to the real property must also be included in the election.

(2) *Time for making election.* The election to treat property as foreclosure property must be made on or before the due date (including extensions of time) for filing the trust's income tax return for the taxable year in which the trust acquires the property with respect to which the election is being made, or April 3, 1975, whichever is later.

(3) *Manner of making the election.* An election made after February 6, 1981, shall be made by a statement attached to the income tax return for the taxable year in which the trust acquired the property with respect to which the election is being made. The statement shall indicate that the election is made under section 856(e) and shall identify the property to which the election applies. The statement shall also set forth—

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired by the trust, and

(iii) A brief description of how the real property was acquired, including the name of the person or persons from whom the real property was acquired and a description of the lease or indebtedness with respect to which default occurred or was imminent.

An election made on or before February 6, 1981 shall be filed in the manner prescribed in 26 CFR 10.1(f) (revised as of April 1, 1977) (temporary regulations relating to the election to treat property as foreclosure property) as in effect when the election is made.

(4) *Status of taxpayer.* In general, a taxpayer may make an election with respect to an acquisition of property only if the taxpayer is a qualified real estate investment trust for the taxable year in which the acquisition occurs. If, however, the taxpayer establishes, to the satisfaction of the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for a taxable year was to due to reasonable cause and not due to willful neglect, the taxpayer may make the election with respect to property acquired in such taxable year. The principles of §§ 1.856.7(c) and 1.856.8(d) (including the principles relating to expert advice) will apply in determining whether, for purposes of this subparagraph, the failure of the taxpayer to be a qualified real estate investment trust for the taxable year in which the property is acquired was due to reasonable cause and not due to willful neglect. If a taxpayer makes a valid election to treat property as foreclosure property, the property will not lose its status as foreclosure property solely because the taxpayer is not a qualified real estate investment trust for a subsequent taxable year (including a taxable year which encompasses an extension of the grace period). However, the rules relating to the ter-

mination of foreclosure property status in section 856(e)(4) (but not the tax on income from foreclosure property imposed by section 857(b)(4)) apply to the year in which the property is acquired and all subsequent years, even though the taxpayer is not a qualified real estate investment trust for such year.

(d) *Termination of 2-year grace period; subsequent leases*—(1) *In general.* Under section 856(e)(4)(A), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which the trust either—

(i) Enters into a lease with respect to any of the property which, by its terms, will give rise to income of the trust which is not described in section 856(c)(3) (other than section 856(c)(3)(F)), or

(ii) Receives or accrues, directly or indirectly, any amount which is not described in section 856(c)(3) (other than section 856(c)(3)(F)) pursuant to a lease with respect to any of the real property entered into by the trust on or after the day the trust acquired the property.

For example, assume the trust acquires, in a particular taxable year, a shopping center upon the default of an indebtedness owed to the trust. Also assume that the trust subsequently enters into a lease with respect to one of several stores in the shopping center that requires the lessee to pay rent to the trust which is not income described in section 856(c)(3) (other than section 856(c)(3)(F)). In such case, the entire shopping center will cease to be foreclosure property on the day the trust enters into the lease.

(2) *Extensions or renewals of leases.* Generally, the extension or renewal of a lease of foreclosure property will be treated as the entering into of a new lease only if the trust has a right to renegotiate the terms of the lease. If, however, by operation of law or by contract, the acquisition of the foreclosure property by the trust terminates a preexisting lease of the property, or gives the trust a right to terminate the lease, then for purposes of section 856(e)(4)(A), a trust, in such circumstances, will not be considered to have entered into a lease with respect to the property solely because the terms of the preexisting lease are continued in effect after foreclosure without substantial modification. The letting of rooms in a hotel or motel does not constitute the entering into a lease for purposes of section 856(e)(4)(A).

(3) *Rent attributable to personal property.* Solely for the purposes of section 856(e)(4)(A), if a trust enters into a lease with respect to real property on or after the day upon which the trust acquires such real property by foreclosure, and a portion of the rent from such lease is attributable to personal property which is foreclosure property incident to such real property, such rent attributable to the incidental personal property will not be considered to terminate the status of such real property (or such incidental personal property) as foreclosure property.

(e) *Termination of 2-year grace period; completion of construction*—(1) *In general.* Under section 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent. If more than one default occurred with respect to an indebtedness or lease in respect of which there is an acquisition, the more-than-10-percent test (including the rule prescribed in this paragraph relating to the test) will not be applied at the time a particular default became imminent if it is clear that the acquisition did not occur as the result of such default. For example, if the debtor fails to make four consecutive payments of principal and interest on the due dates, and the trust takes action to acquire the property securing the debt only after the fourth default becomes imminent, the 10-percent test is applied at the time the fourth default became imminent (even though the trust would not have foreclosed on the property had not all four defaults occurred).

(2) *Determination of percentage of completion.* The determination of whether the construction of a building or other improvement was more than 10 percent complete when default became imminent shall be made by comparing the total direct costs of construction incurred with respect to the building or other improvement as of the date default became imminent with the estimated total direct costs of construction as of such date. If the building or other improvement qualifies as more than 10 percent complete under this method, the building or other improvement shall be considered to be more than 10 percent complete. For purposes of this subparagraph, direct costs of construction include the cost of labor and materials which are directly connected with the construction of the building or improvement.

Thus, for example, direct costs of construction incurred as of the date default became imminent would include amounts paid, or for which liability has been incurred, for labor which has been performed as of such date that is directly connected with the construction of the building or other improvement and for building materials and supplies used or consumed in connection with the construction as of such date. For purposes of applying the 10-percent test the trust may also take into account the cost of building materials and supplies which have been delivered to the construction site as of the date default became imminent and which are to be used or consumed in connection with the construction. On the other hand, architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits are not considerd to be direct costs of construction. Any construction by the trust as mortgagee-in-possession is considered to have taken place after default resulting in acquisition of the property became imminent. Generally, the trust's estimate of the total direct costs of completing construction as of the date the default became imminent will be accepted, provided that the estimate is reasonable, in good faith, and is based on all of the data reasonably available to the trust when the trust undertakes completion of construction of the building or other improvement. Appropriate documentation which shows that construction was more than 10 percent complete when default became imminent must be available at the principal place of business of the trust for inspection in connection with an examination of the income tax return. Construction includes the renovation of a building, such as the remodeling of apartments, or the renovation of an apartment building to convert rental units to a condominium. The renovation must be more than 10 percent complete (determined by comparing the total direct cost of the physical renovation which has been incurred when default became imminent with the estimated total direct cost of renovation as of such date) when default became immiment in order for the property not to lose its status as foreclosure property if the trust undertakes the renovation.

(3) *Modification of a building or improvement.* Generally, the terms "building" and "improvement" in section 856(e)(4)(B) mean the building or improvement (including any intergral part thereof) as planned by the mortgagor or lessee (or other person in possession of the property, if appropriate) as of the date default became imminent. The trust, however, may estimate the total direct costs of construction and complete the construction of the building or other improvement by modifying the building or other improvement as planned as of the date default became imminent so as to reduce the estimated direct cost of construction of the building or improvement. If the trust does so modify the planned construction of the building or improvement, the 10-percent test is to be applied by comparing the direct costs of construction incurred as of the date default became imminent that are attributable to the building or

improvement as modified, with the estimated total direct costs (as of such date) of construction of the building or other improvement as modified. The trust, in order to meet the 10-percent test, may not, however, modify the planned building or improvement by reducing the estimated direct cost of construction to such an extent that the building or improvement is not functional.

Also, the trust may make subsequent modifications which increase the direct cost of construction of the building or improvement if such modifications—

(i) Are required by a Federal, State, or local agency, or

(ii) Are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent.

Subdivision (ii) of the preceding sentence applies, however, only if the building or improvement, as modified, was more than 10 percent complete when default became imminent. A building completed by the trust will not cease to be foreclosure property solely because the building is used in a manner other than that planed by the defaulting mortgagor or lessee. Thus, for example, assume a trust acquired on foreclosure a planned apartment building which was 20 percent complete when default became imminent and that the trust completes the building without modifications which increase the direct cost of construction. The property will not cease to be foreclosure property by reason of section 856(e)(4)(B) solely because the trust sells the dwelling units in the building as condominium units, rather than holding them for rent as planned by the defaulting mortgagor. (See, however, section 856(e)(4)(C) and paragraph (f)(2) of this section for rules relating to the requirement that where foreclosure property is used in a trade or business (including a trade or business of selling the foreclosure property), the trade or business must be conducted through an independent contractor after 90 days after the property is acquired.)

(4) *Application on building-by-building basis.* Generally the more than 10 percent test is to be applied on a building-by-building basis. Thus, for example, if a trust has foreclosed on land held by a developer building a housing subdivision, the trust may complete construction of the houses which were more than 10 percent complete when default became imminent. The trust, however, may not complete construction of houses which were only 10 percent (or less) complete, nor may the trust begin construction of other houses planned for the subdivision on which construction has not begun. The trust, however, may construct an additional building or improvement (whether or not the construction thereof has begun) which is an integral part of another building or other improvement that was more than 10 percent complete when default became imminent if the additional building or improvement and the other building or improvement, taken together as a unit, meet the more than 10 percent test. For purposes of this paragraph, an additional building or other improvement will be considered to be an integral part of another building or improvement if—

(i) It is ancillary to the other building or improvement and its principal intended use is to furnish services or facilities which either supplement the use of such other building or improvement or are necessary for such other building or improvement to be utilized in the manner or for the purpose for which it is intended, or

(ii) The buildings or improvements are intended to comprise constituent parts of an interdependent group of buildings or other improvements.

However, a building or other improvement will not be considered to be an integral part of another building or improvement unless the buildings or improvements were planned as part of the same overall construction plan or project before default became imminent. An additional building or other improvement (such as, for example, an outdoor swimming pool or a parking garage) may be considered to be an integral part of another building or improvement, even though the additional building or improvement was also intended to be used to provide facilities or services for use in connection with several other buildings or improvements which will not be completed. If the trust chooses not to undertake the construction of an additional building or other improvement which qualifies as an integral part of another building or improvement, so much of the costs of construction (including both the direct costs of construction incurred before the default became imminent and the estimated costs of completion) as are attributable to that "integral part" shall not be taken into account in determining whether any other building or improvement was more than 10 percent complete when default became imminent. For example, assume the trust acquires on foreclosure a property on which the defaulting mortgagor has begun construction of a motel. The motel, as planned by the mortgagor, was to consist of a two-story building containing 30 units, and two detached one-story wings, each of which was to contain 20 units. At the time default became imminent, the defaulting mortgagor had completed more than 10 percent of the construction of the two-story structure but the two wings, an access road, a parking lot, and an outdoor swimming pool planned for the motel were each less than 10 percent complete. The trust may construct the two wings of the motel, the access road, the parking lot, and the swimming pool: *Provided*, That the motel and the other improvements which the trust undertakes to construct, taken together as a unit, were more than 10 percent complete when default became imminent. If, however, the trust chooses not to undertake construction of the swimming pool, the cost of construction attributable to the swimming pool, whether incurred before default became imminent or estimated as the cost of completion, shall not be taken into account in determining whether the trust can complete construction of the other buildings and improvements. For another example, assume that the trust acquires a planned shopping center on foreclosure. At the time default became imminent several large buildings intended to house shops and stores in the shopping center were more than 10 percent complete. Less than 10 percent of the construction, however, had been completed on a separate structure intended to house a bank. The bank was planned as a component of the shopping center in order to provide, in conjunction with the other shops and stores, a specific range and variety of goods and services with which to attract customers to the shopping center. The trust may complete construction of the bank: *Provided*, That the bank and the other buildings and improvements which the trust undertakes to complete, taken together as a unit, were more than 10 percent complete when default became imminent. If the trust chooses not to construct the bank, no actual or estimated construction costs attributable to the bank are to be taken into account in applying the 10-percent test with respect to the other buildings and improvements in the shopping center. For a third example, assume that a defaulting mortgagor had planned to construct two identical apartment buildings, A and B, on the same tract of land, that neither building is to provide substantial facilities or services to be used in connection with the other, and that only building A was more than 10 percent complete when default became imminent. The trust, in this case, may not complete building B. On the other hand, if the facts are the same except that pursuant to the plans of the defaulting mortgagor, one of the buildings is to contain the furnace and central air conditioning machinery for both buildings A and B, the trust may complete both buildings A and B: *Provided*, That, taken together as a unit, the two buildings meet the more-than-10-percent test.

(5) *Repair and maintenance.* Under this paragraph (e), "construction" does not include—

(i) The repair or maintenance of a building or other improvement (such as the replacement of worn or obsolete furniture and appliances) to offset normal wear and tear or obsolescence, and the restoration of property required because of damage from fire, storm, vandalism or other casualty,

(ii) The preparation of leased space for a new tenant which does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, or

(iii) The performing of repair or maintenance described in paragraph (e)(5)(i) of this section after property is acquired that was deferred by the defaulting party and that does not constitute renovation under paragraph (e)(2) of this section.

(6) *Independent contractor required.* If any construction takes place on the foreclosure property more than 90 days after the day on which such property was acquired by the trust, such construction must be performed by an independent contractor (as defined in section 856(d)(3) and § 1.856-4(b)(5)(iii)) from whom the trust does not derive or receive any income. Otherwise, the property will cease to be foreclosure property.

(7) *Failure to complete construction.* Property will not cease to be foreclosure property solely because a trust which undertakes the completion of construction of a building or other improvement on the property that was more than 10 percent complete when default became imminent does not complete the construction. Thus, for example, if a trust continues construction of a building that was 20 percent complete when default became imminent, and the trust constructs an additional 40 percent of the building and then sells the property, the property will not lose its status as foreclosure property solely because the trust fails to complete construction of the building.

(f) *Termination of 2-year grace period; use of foreclosure property in a trade or business*—(1) *In general.* Under section 856(e)(4)(C), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring more than 90 days after the day on which the trust acquired the property) on which the property is used in a trade or business conducted by the trust, other than a trade or business conducted by the trust through an independent contractor from whom the trust itself does not derive or receive any income. (See section 856(d)(3) for the definition of independent contractor.)

(2) *Property held primarily for sale to customers.* For the purposes of section 856(e)(4)(C), foreclosure property held by the trust primarily for sale to customers in the ordinary course of a trade or business is considered to be property used in a trade or business conducted by the trust. Thus, if a trust holds foreclosure property (whether real property or personal property incident to real property) for sale to customers in the ordinary course of a trade or business more than 90 days after the day on which the trust acquired the real property, the trade or business of selling the property must be conducted by the trust through an independent contractor from whom the trust does not derive or receive any income. Otherwise, after such 90th day the property will cease to be foreclosure property.

(3) *Change in use.* Foreclosure property will not cease to be foreclosure property solely because the use of the property in a trade or business by the trust differs from the use to which the property was put by the person from whom it was acquired. Thus, for example, if a trust acquires a rental apartment building on foreclosure, the property will not cease to be foreclosure property solely because the trust converts the building to a condominium apartment building and, through an independent contractor from whom the trust derives no income, engages in the trade or business of selling the individual condominium units.

(g) *Extension of 2-year grace period*—(1) *In general.* A real estate investment trust may apply to the district director of the internal revenue district in which is located the principal place of business (or principal office or agency) of the trust for an extension of the 2-year grace period. If the trust establishes to the satisfaction of the district director that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in foreclosure property, or for an orderly renegotiation of a lease or leases of the property, the district director may extend the 2-year grace period. See section 856(e)(3) (as in effect with respect to the particular extension) for rules relating to the maximum length of an extension, and the number of extensions which may be granted. An extension of the grace period may be granted by the district director either before or after the date on which the grace period, but for the extension, would expire. The extension shall be effective as of the date on which the grace period, but for the extension, would expire.

(2) *Showing required.* Generally, in order to establish the necessity of an extension, the trust must demonstrate that it has made good faith efforts to renegotiate leases with respect to, or dispose of, the foreclosure property. In certain cases, however, the trust may establish the necessity of an extension even though it has not made such efforts. For example, if the trust demonstrates that, for valid business reasons, construction of the foreclosure property could not be completed before the expiration of the grace period, the necessity of the extension could be established even though the trust had made no effort to sell the property. For another example, if the trust demonstrates that due to a depressed real estate market, it could not sell the foreclosure property before the expiration of the grace period except at a distress price, the necessity of an extension could be established even though the trust had made no effort to sell the property. The fact that property was acquired as foreclosure property prior to January 3, 1975 (the date of enactment of section 856(e)), generally will be considered as a factor (but not a controlling factor) which tends to establish that an extension of the grace period is necessary.

(3) *Time for requesting an extension of the grace period.* A request for an extension of the grace period must be filed with the appropriate district director more than 60 days before the day on which the grace period would otherwise expire. In the case of a grace period which would otherwise expire before August 6, 1976, a request for an extension will be considered to be timely filed if filed on or before June 7, 1976.

(4) *Information required.* The request for an extension of the grace period shall identify the property with respect to which the request is being made and shall also include the following information:

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired as foreclosure property by the trust,

(iii) The taxable year of the trust in which the property was acquired,

(iv) If the trust has been previously granted an extension of the grace period with respect to the property, a statement to that effect (which shall include the date on which the grace period, as extended, expires) and a copy of the information which accompanied the request for the previous extension,

(v) A statement of the reasons why the grace period should be extended,

(vi) A description of any efforts made by the trust after the acquisition of the property to dispose of the property or to renegotiate any lease with respect to the property, and

(vii) A description of any other factors which tend to establish that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in the property, or for an orderly renegotiation of a lease or leases of the property.

The trust shall also furnish any additional information requested by the district director after the request for extension is filed.

(5) *Automatic extension.* If a real estate investment trust files a request for an extension with the district director more than 60 days before the expiration of the grace period, the grace period shall be considered to be extended until the end of the 30th day after the date on which the district director notifies the trust by certified mail sent to its last known address that the period of extension requested by the trust is not granted. In no event, however, shall the rule in the

preceding sentence extend the grace period beyond the expiration of (i) the period of extension requested by the trust, or (ii) the 1-year period following the date that the grace period (but for the automatic extension) would expire. The date of the postmark on the sender's receipt is considered to be the date of the certified mail for purposes of this subparagraph. This subparagraph does not apply, however, if the date of the notification by certified mail described in the first sentence is more than 30 days before the date that the grace period (determined without regard to this subparagraph) expires. Moreover, this subparagraph shall not operate to allow any period of extension that is prohibited by the last sentence of section 856(e)(3) (as in effect with respect to the particular extension).

(6) *Extension of time for filing.* If a real estate investment trust fails to file the request for an extension of the grace period within the time provided in paragraph (g)(3) of this section, then the district director shall grant a reasonable extension of time for filing such request, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the request within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(7) *Status of taxpayer.* The reference to "real estate investment trust" or "trust" in this paragraph (g) shall be considered to include a taxpayer that is not a qualified real estate investment trust, if the taxpayer establishes to the satisfaction of the district director that its failure to be a qualified real estate investment trust for the taxable year was due to reasonable cause and not due to willful neglect. The principles of § 1.856-7(c) and § 1.856-8(d) (including the principles relating to expert advice) shall apply for determining reasonable cause (and absence of willful neglect) for this purpose.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11269, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981]

§ 1.856-7 Certain corporations, etc., that are considered to meet the gross income requirements.

(a) *In general.* A corporation, trust, or association which fails to meet the requirements of paragraph (2) or (3) of section 856(c), or of both such paragraphs, for any taxable year nevertheless is considered to have satisfied these requirements if the corporation, trust, or association meets the requirements of subparagraphs (A), (B), and (C) of section 856(c)(7) (relating to a schedule attached to the return, the absence of fraud, and reasonable cause).

(b) *Contents of the schedule.* The schedule required by subparagraph (A) of section 856(c)(7) must contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c) (2) and (3). Thus, for example, the real estate investment trust, for purposes of listing its income from the sources described in section 856(c)(2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. The listing is not required to be on a lease-by-lease, loan-by-loan, or project-by-project basis, but the real estate investment trust must maintain adequate records on such a basis with which to substantiate each total amount listed in the schedule.

(c) *Reasonable cause*—(1) *In general.* The failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) will be considered due to reasonable cause and not due to willful neglect if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust. However, even if the trust exercised ordinary business care and prudence in entering into a transaction, if the trust later determines that the transaction results in the receipt or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the trust's overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the trust must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source requirement will be considered due to willful neglect and not due to reasonable cause if the failure is willful and the trust could have avoided such failure by taking actions not inconsistent with ordinary business care and prudence. For example, if the trust enters into a lease knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed, the failure is due to willful neglect even if the trust has a legitimate business purpose for entering into the lease.

(2) *Expert advice*—(i) *In general.* The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes "reasonable cause" if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs). The absence of such a reasoned, written opinion with respect to a transaction does not, by itself, give rise to any inference that the failure to meet a percentage of income requirement was without reasonable cause. An opinion as to the character of income from a transaction includes an opinion pertaining to the use of a standard form of transaction or standard operating procedure in a case where such standard form or procedure is in fact used or followed.

(ii) If the opinion indicates that a portion of the income from a transaction will be nonqualifed income, the trust must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of its overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed. Reliance on an opinion is not reasonable if the trust has reason to believe that the opinion is incorrect (for example, because the trust withholds facts from the person rendering the opinion).

(iii) *Reasoned written opinion.* For purposes of this subparagraph (2), a written opinion means an opinion, in writing, rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. A written opinion is considered "reasoned" even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion is based on a full disclosure of the factual situation by the real estate investment trust and is addressed to the facts and law which the person rendering the opinion believes to be applicable. However, an opinion is not considered "reasoned" if it does nothing more than recite the facts and express a conclusion.

(d) *Application of section 856(c)(7) to taxable years beginning before October 5, 1976.* Pursuant to section 1608(b) of the Tax Reform Act of 1976, paragraph (7) of section 856(c) and this section apply to a taxable year of a real estate investment trust which begins before October 5, 1976, only if as the result of a determination (as defined in section 859(c)) occurring after October 4, 1976, the trust does not meet the requirements of paragraph (2) or (3) of section 856(c), or both paragraphs, as in effect for the taxable year. The requirement that the schedule described in subparagraph (A) of section 856(c)(7) be attached to the income tax return of a real estate investment trust in order for section 856(c)(7) to apply is not applicable to taxable years beginning before October 5, 1976. For purposes of section 1608(b) of the Tax Reform Act of 1976 and this paragraph, the rules relating to determinations prescribed in § 1.859-2(b)(1) (other than the second sentence and the last sentence of § 859-2(b)(1)(iv)) shall apply. However, a determination consisting of an agreement between the taxpayer and the district director (or other official to whom authority to sign the agreement is delegated) shall set forth the amount of gross income for the taxable year to which the determination applies, the amount of the 90 percent and 75 percent source-of-income requirements for the taxable year to which the determination applies, and the amount by which the real estate investment trust failed to meet either or both of the requirements. The agreement shall also set forth the amount of tax for which the trust is liable pursuant to section 857(b)(5). The agreement shall also contain a finding as to whether the failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) was due to reasonable cause and not due to willful neglect.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11274, Feb. 6, 1981]

§ 1.856-8 Revocation or termination of election.

(a) *Revocation of an election to be a real estate investment trust.* A corporation, trust, or association that has made an election under section 856(c)(1) to be a real estate investment trust may revoke the election for any taxable year after the first taxable year for which the election is effective. The revocation must be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement must be filed on or before the 90th day after the first day of the first taxable year for which the revocation is to be effective. The statement must be signed by an official authorized to sign the income tax return of the taxpayer and must—

(1) Contain the name, address, and taxpayer identification number of the taxpayer,

(2) Specify the taxable year for which the election was made, and

(3) Include a statement that the taxpayer, pursuant to section 856(g)(2), revokes its election under section 856(c)(1) to be a real estate investment trust.

The revocation may be made only with respect to a taxable year beginning after October 4, 1976, and is effective for the taxable year in which made and for all succeeding taxable years. A revocation with respect to a taxable year beginning after October 4, 1976, that is filed before February 6, 1981, in the time and manner prescribed in § 7.856(g)-1 of this chapter (as in effect when the revocation was filed) is considered to meet the requirements of this paragraph.

(b) *Termination of election to be a real estate investment trust.* An election of a corporation, trust, or association under section 856(c)(1) to be a real estate investment trust shall terminate if the corporation, trust, or association is not a qualified real estate investment trust for any taxable year (including the taxable year with respect to which the election is made) beginning after October 4, 1976. (This election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.) The term "taxable year" includes a taxable year of less than 12 months for which a return is made under section 443. The termination of the election is effective for the first taxable year beginning after October 4, 1976, for which the corporation, trust, or association is not a qualified real estate investment trust and for all succeeding taxable years.

(c) *Restrictions on election after termination or revocation*—(1) *General rule.* Except as provided in paragraph

(d) of this section, if a corporation, trust, or association has made an election under section 856(c)(1) to be a real estate investment trust and the election has been terminated or revoked under section 856(g)(1) or (2), the corporation, trust, or association (and any successor corporation, trust, or association) is not eligible to make a new election under section 856(c)(1) for any taxable year prior to the fifth taxable year which begins after the first taxable year for which the termination or revocation is effective.

(2) *Successor corporation.* The term "successor corporation, trust, or association", as used in section 856(g)(3), means a corporation, trust, or association which meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation, trust, or association whose election has been terminated under section 856(g)(1) or revoked under section 856(g)(2). A corporation, trust, or association meets the continuity of ownership requirement only if at any time during the taxable year the persons who own, directly or indirectly, 50 percent or more in value of its outstanding shares owned, at any time during the first taxable year for which the termination or revocation was effective, 50 percent or more in value of the outstanding shares of the corporation, trust, or association whose election has been terminated or revoked. A corporation, trust, or association meets the continuity of assets requirement only if either (i) a substantial portion of its assets were assets of the corporation, trust, or association whose election has been revoked or terminated, or (ii) it acquires a substantial portion of the assets of the corporation, trust, or association whose election has been terminated or revoked.

(3) *Effective date.* Section 856(g)(3) does not apply to the termination of an election that was made by a taxpayer pursuant to section 856(c)(1) on or before October 4, 1976, unless the taxpayer is a qualified real estate investment trust for a taxable year ending after October 4, 1976, for which the pre-October 5, 1976, election is in effect. For example, assume that Trust X, a calendar year taxpayer, files a timely election under section 856(c)(1) with respect to its taxable year 1974, and is a qualified real estate investment trust for calendar years 1974 and 1975. Assume further that Trust X is not a qualified real estate investment trust for 1976 and 1977 because it willfully fails to meet the asset diversification requirements of section 856(c)(5) for both years. The failure (whether or not willful) to meet these requirements in 1977 terminates the election to be a real estate investment trust made with respect to 1974. (See paragraph (b) of this section.) The termination is effective for 1977 and all succeeding taxable years. However, under section 1608(d)(3) of the Tax Reform Act of 1976, Trust X is not prohibited by section 856(g)(3) from making a new election under section 856(c)(1) with respect to 1978.

(d) *Exceptions*—Section 856(g)(4) provides an exception to the general rule of section 856(g)(3) that the termination of an election to be a real estate investment trust disqualifies the corporation, trust, or association from making a new election for the 4 taxable years following the first taxable year for which the termination is effective. This exception applies where the corporation, trust, or association meets the requirements of section 856(g)(4)(A), (B) and (C) (relating to the timely filing of a return, the absence of fraud, and reasonable cause, respectively) for the taxable year with respect to which the termination of election occurs. In order to meet the requirements of section 856(g)(4)(C), the corporation, trust, or association must establish, to the satisfaction of the district director for the internal revenue district in which the corporation, trust, or association maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for the taxable year in question was due to reasonable cause and not due to willful neglect. The principles of § 1.856-7(c) (including the principles relating to expert advice) will apply in determining whether, for purposes of section 856(g)(4), the failure of a corporation, trust, or association to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect. Thus, for example, the corporation, trust, or association must exercise ordinary business care and prudence in attempting to meet the status conditions of section 856(a) and the distribution and recordkeeping requirements of section 857(a), as well as the gross income requirements of section 856(c). The provisions of section 856(g)(4) do not apply to a taxable year in which the corporation, trust, or association makes a valid revocation, under section 856(g)(2), of an election to be a real estate investment trust.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11275, Feb. 6, 1981; 46 FR 15263, Mar. 5, 1981]

§ 1.856-9 Election with respect to property held for sale in a taxable year beginning before October 5, 1976.

(a) *In general.* Section 856(a)(4), as in effect with respect to taxable years beginning before October 5, 1976, provided that a real estate investment trust could not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Section 1603 of the Tax Reform Act of 1976 (the Act) repealed the prohibition on holding property primarily for sale to customers, effective for taxable years beginning after October 4, 1976, and imposed the tax on net income from prohibited transactions under section 857(b)(6). Section 1608(d)(2) of the Act provides that if as a result of a determination (as defined in section 859(c)) occurring after October 4, 1976, a real estate investment trust does not meet the requirement of section 856(a)(4) (as in effect before amendment by the Act) for any taxable year beginning before October 5, 1976, the trust may elect to have the provisions of section 1603 (other than paragraphs (1), (2), (3), and (4) of section 1603(c)) of the Act apply with respect to the taxable year.

(b) *Election.* The election provided by section 1608(d)(2) of the Act shall be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement shall be signed by the taxpayer and shall include the following information:

(1) The name, address, and taxpayer identification number of the taxpayer;

(2) The taxable year (or years) to which the election applies;

(3) A statement that the taxpayer, pursuant to section 1608(d)(2) of the Tax Reform Act of 1976, elects to have the provisions of section 1603 (other than paragraphs (1), (2), (3), and (4) of section 1603(c)) of the Act apply to such taxable year (or years); and

(4) A description of the determination and the date upon which the determination became final.

A copy of the closing agreement, the Tax Court decision, the judgement, decree, or other order, or the agreement with the district director (or other official) which constitutes the determination shall be attached to the statement.

(c) *Time for filing the election.* The election must be filed within 60 days after the date of the determination. The date of a determination described in section 859(c) (1) or (2) shall be determined in accordance with section 859(c) and subdivision (i), (ii), or (iii) of § 1.859-2(b)(1). The date of a determination which is an agreement with the district director (or other official) under section 859(c)(3) shall be determined in accordance with paragraph (e) of this section.

(d) *Revocation*—(1) *In general.* An election made by a taxpayer pursuant to section 1608(d)(2) of the Tax Reform Act of 1976 after February 6, 1981 is irrevocable.

(2) *Elections made under temporary regulations.* A taxpayer who has made an election under section 1608(d)(2) of the Act on or before February 6, 1981

in accordance with § 7.0(c)(1) of this chapter may apply to the Commissioner for consent to revoke the election. The application for consent must be filed with the Commissioner after February 6, 1981 and before May 8, 1981.

(e) *Determination* . For purposes of section 1608(d)(2) of the Tax Reform Act of 1976, a determination under section 859(c)(3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall identify the taxable year (or years) to which it applies and shall state that the taxpayer, during such taxable year (or years), held property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business, within the meaning of section 856(c)(4), as in effect before amendment by the Act. The agreement further shall set forth, for each taxable year to which it applies, the amount, if any, of the net income (or net loss) from prohibited transactions, and the amount, if any, of the tax imposed by paragraph (6) of section 857(b). An agreement under this subparagraph shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration shall be treated as the date of determination. If certified mail is used, the date of the postmark on the sender's receipt shall be treated as the date of determination. However, if the statement described in paragraph (b) of this section is filed by the taxpayer before the registration or postmark date but on or after the date the agreement is signed by the district director (or the other official to whom authority to sign the agreement is delegated), the date of determination shall be the date of signing.

(f) *Rules relating to refunds, credits, assessment, and collection.* In a case where an election to have section 1603 of the Act apply results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X. See section 1608(d)(2) of the Act for special rules relating to the period of limitations on filing the claim and to assessment and collection of any deficiency established by the determination.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11276, Feb. 6, 1981]

§ 1.857-1 Taxation of real estate investment trusts.

(a) *Requirements applicable thereto.* Section 857(a) denies the application of the provisions of part II, subchapter M, chapter 1 of the Code (other than sections 856(g), relating to the revocation or termination of an election, and 857(d), relating to earnings and profits) to a real estate investment trust for a taxable year unless—

(1) The deduction for dividends paid for the taxable year as defined in section 561 (computed without regard to capital gain dividends) equals or exceeds the amount specified in section 857(a)(1), as in effect for the taxable year; and

(2) The trust complies for such taxable year with the provisions of § 1.857-8 (relating to records required to be maintained by a real estate investment trust).

See section 858 and § 1.858-1, relating to dividends paid after the close of the taxable year.

(b) *Failure to qualify.* If a real estate investment trust does not meet the requirements of section 857(a) and paragraph (a) of this section for the taxable year, it will, even though it may otherwise be classified as a real estate investment trust, be taxed in such year as an ordinary corporation and not as a real estate investment trust. In such case, none of the provisions of part II of subchapter M (other than sections 856(g) and 857(d)) will be applicable to it. For the rules relating to the applicability of sections 856(g) and 857(d), see § 1.857-7.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)), sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4087, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857-2 Real estate investment trust taxable income and net capital gain.

(a) *Real estate investment trust taxable income.* Section 857(b)(1) imposes a nomal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the "real estate investment trust taxable income", as defined in section 857(b)(2). Section 857(b)(2) requires certain adjustments to be made to convert taxable income of the real estate investment trust to "real estate investment trust taxable income". The adjustments are as follows:

(1) *Net capital gain.* In the case of taxable years ending before October 5, 1976, the net capital gain, if any, is excluded.

(2) *Special deductions disallowed.* The special deductions provided in part VIII, subchapter B, chapter 1 of the Code (except the deduction under section 248) are not allowed.

(3) *Deduction for dividends paid*—(i) *General rule.* The deduction for dividends paid (as defined in section 561) is allowed. In the case of taxable years ending before October 5, 1976, the deduction for dividends paid is computed without regard to capital gains dividends.

(ii) *Deduction for dividends paid if there is net income from foreclosure property.* If for any taxable year the trust has net income from foreclosure property (as defined in section 857(b)(4)(B) and § 1.857-3), the deduction for dividends paid is an amount equal to the amount which bears the same proportion to the total dividends paid or considered as paid during the taxable year that otherwise meet the requirements for the deduction for dividends paid (as defined in section 561) as the real estate investment trust taxable income (determined without regard to the deduction for dividends paid) bears to the sum of—

(A) The real estate investment trust taxable income (determined without regard to the deduction for dividends paid), and

(B) The amount by which the net income from foreclosure property exceeds the tax imposed on such income by section 857(b)(4)(A).

For purposes of the preceding sentence, the term "total dividends paid or considered as paid during the taxable year" includes deficiency dividends paid with respect to the taxable year that are not otherwise excluded under this subdivision or section 857(b)(3)(A). The term, however, does not include either deficiency dividends paid during the taxable year with respect to a preceding taxable years ending before October 5, 1976, capital gains dividends.

(iii) *Deduction for dividends paid for purposes of the alternative tax.* The rules in section 857(b)(3)(A) apply in determining the amount of the deduction for dividends paid that is taken into account in computing the alternative tax. Thus, for example, if a real estate investment trust has net income from foreclosure property for a taxable year ending after October 4, 1976, then for purposes of determining the partial tax described in section 857(b)(3)(A)(i), the amount of the deduction for dividends paid is computed pursuant to paragraph (a)(3)(ii) of this section, except that capital gains dividends are excluded from the dividends paid or considered as paid during the taxable year, and the net capital gain is excluded in computing real estate investment trust taxable income.

(4) *Section 443(b) disregarded.* The taxable income is computed without regard to seciton 443(b). Thus, the taxable income for a period of less than 12 months is not placed on an annual basis even though the short

taxable year results from a change of accounting period.

(5) *Net operating loss deduction.* In the case of a taxable year ending before October 5, 1976, the net operating loss deduction provided in section 172 is not allowed.

(6) *Net income from foreclosure property.* An amount equal to the net income from foreclosure property (as defined in section 857(b)(4)(B) and paragraph (a) of § 1.857-3), if any, is excluded.

(7) *Tax imposed by section 857(b)(5).* An amount equal to the tax (if any) imposed on the trust by section 857(b)(5) for the taxble year is excluded.

(8) *Net income or loss from prohibited transactions.* An amount equal to the amount of any net income derived from prohibited transactions (as defined in section 857(b)(6)(B)(i)) is excluded. On the other hand, an amount equal to amount of any net loss derived from prohibited transactions (as defined in section 857(b)(6)(B)(ii)) is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by section 857(b)(2) and this section are made, the effect of including an amount equal to the amount of the loss is to disallow a deduction for the loss.

(b) *Net capital gain in taxable years ending October 5, 1976.* The rules relating to the taxation of capital gains in 26 CFR 1.857-2(b) (revised as of April 1, 1977) apply to taxable years ending before October 5, 1976.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857-3 Net income from foreclosure property.

(a) *In general.* For purposes of section 857(b)(40(B), net income from foreclosure property means the aggregate of—

(1) All gains and losses from sales or other dispositions of foreclosure property described in section 1221(1), and.

(2) The difference (hereinafter called "net gain or loss from operations") between (i) the gross income derived from foreclosure property (as defined in section 856(e)) to the extent such gross income is not described in subparagraph (A), (B), (C), (D), (E), or (G) of section 856(c)(3), and (ii) the deductions allowed by chapter 1 of the Code which are directly connected with the production of such gross income.

Thus, the sum of the gains and losses from sales or other dispositions of foreclosure property described in section 1221(1) is aggregated with the net gain or loss from operations in arriving at net income from foreclosure property. For example, if for a taxable year a real estate investment trust has gain of $100 from the sale of an item of foreclosure property described in section 1221(1), a loss of $50 from the sale of an item of foreclosure property described in section 1221(1), gross income of $25 from the rental of foreclosure property that is not gross income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3), and deductions of $35 allowed by chapter 1 of the Code which are directly connected with the production of the rental income, the net income from foreclosure property for the taxable years is $40 (($100−$50)+($25−$35)).

(b) *Directly connected deductions.* A deduction which is otherwise allowed by chapter 1 of the Code is "directly connected" with the production of gross income from the foreclosure property if it has a proximate and primary relationship to the earning of the income. Thus, in the case of gross income from real property that is foreclosure property, "directly connected" deductions would include depreciation on the property, interest paid or accrued on the indebtedness of the trust (whether or not secured by the property) to the extent attributable to the carrying of the property, real estate taxes, and fees paid to an independent contractor hired to manage the property. On the other hand, general overhead and administrative expenses of the trust are not "directly connected" deductions. Thus, salaries of officers and other administrative employees of the trust are not "directly connected" deductions. The net operating loss deduction provided by section 172 is not allowed in computing net income from foreclosure property.

(c) *Net loss from foreclosure property.* The tax imposed by section 857(b)(4) applies only if there is net income from foreclosure property. If there is a net loss from foreclosure property (that is, if the aggregate computed under paragraph (a) of this section results in a negative amount) the loss is taken into account in computing real estate investment trust taxable income under section 857(b)(2).

(d) *Gross income not subject to tax on foreclosure property.* If the gross income derived from foreclosure property consists of two classes, a deduction directly connected with the production of both classes (including interest attributable to the carrying of the property) must be apportioned between them. The two classes are:

(1) Gross income which is taken into account in computing net income from froeclosure property and

(2) Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

(e) *Allocation and apportionment of interest.* For purposes of determining the amount of interest attributable to the carrying of foreclosure property under paragraph (b) of this section, the following rules apply:

(1) *Deductible interest.* Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.

(2) *Interest specifically allocated to property.* Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured only by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.

(3) *Other interest.* Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of § 1.861-8(e)(2)(v).

(4) *Effective date.* The rules in this paragraph (e) are mandatory for all taxable years ending after February 6, 1981.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857-4 Tax imposed by reason of the failure to meet certain source-of-income requirements.

Section 857(b)(5) imposes a tax on a real estate investment trust that is considered, by reason of section 856(c)(7), as meeting the source-of-income requirements of paragraph (2) or (3) of section 856(c) (or both such paragraphs). The amount of the tax is determined in the manner prescribed in section 857(b)(5).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 2, 1981]

§ 1.857-5 Net income and loss from prohibited transactions.

(a) *In general.* Section 857(b)(6) imposes, for each taxable year, a tax equal to 100 percent of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property described in section 1221(1) that is not foreclosure property. The 100-percent tax is imposed to preclude a real estate investment trust from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development tract. In order to prevent a trust from receiving any tax benefit from such activities, a net loss from prohibited transactions effectively is disallowed in compting real estate investment trust taxable income. See § 1.857-2(a)(8). Such loss, however, does reduce the amount which a trust is required to distribute as dividends. For purposes of applying the provisions of the Code, other than those provisions of part II of subchapter M which relate to prohibited transactions, no inference is to be drawn from the fact that a type of transaction does not constitute a prohibited transaction.

(b) *Special rules.* In determining whether a particular transaction constitutes a prohibited transaction, the activities of a real estate investment trust with respect to foreclosure property and its sales of such property are disregarded. Also, if a real estate investment trust enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period, and the seller exercises the option pursuant to its terms, income from the sale generally will not be considered to be income from a prohibited transaction solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. Other facts and circumstances, however, may require a conclusion that the property is held primarily for sale to customers in the ordinary course of a trade or business. Gain from the sale or other disposition of property described in section 1221(1) (other than foreclosure property) that is included in gross income for a taxable year of a qualified real estate investment trust constitutes income from a prohibited transaction, even though the sale or other disposition from which the gain is derived occurred in a prior taxable year. For example, if a corporation that is a qualified real estate investment trust for the current taxable year elected to report the income from the sale of an item of section 1221(1) property (other than foreclosure property) on the installment method of reporting income, the gain from the sale that is taken into income by the real estate investment trust for the current taxable year is income from a prohibited transaction. This result follows even though the sale occurred in a prior taxable year for which the corporation did not qualify as a real estate investment trust. On the other hand, if the gain is taken into income in a taxable year for which the taxpayer is not a qualifed real estate investment trust, the 100-percent tax does not apply.

(c) *Net income or loss from prohibited transactions.* Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses from the sale or other disposition of such property. Thus, for example, if a real estate investment trust sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of $100 on the sale of one item and a loss of $40 on the sale of the second item, the net income from prohibited transactions will be $60.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749. 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805). Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 6, 1981]

§ 1.857-6 Method of taxation of shareholders of real estate investment trusts.

(a) *Ordinary income.* Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a real estate investment trust shall include such dividends in gross income for the taxable year in which they are received. See section 858(b) and paragraph (c) of § 1.858-1 for treatment by shareholders of dividends paid by a real estate investment trust after the close of its taxable year in the case of an election under section 858(a).

(b) *Capital gains.* Under section 857(b)(3)(B), shareholders of a real estate investment trust who receive capital gain dividends (as defined in paragraph (e) of this section), in respect of the capital gains of a corporation, trust, or association for a taxable year for which it is taxable under part II of subchapter M as a real estate investment trust, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend which in his hands is gain to which section 1201(d) (1) or (2) applies is the portion so designated by the real estate investment trust pursuant to paragraph (e)(2) of this section.

(c) *Special treatment of loss on the sale or exchange of real estate investment trust stock held less than 31 days*—(1) *In general.* Under section 857(b)(7), if any person with respect to a share of real estate investment trust stock held for a period of less than 31 days, is required by section 857(b)(3)(B) to include in gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) the amount of a capital gains dividend, then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(2) *Determination of holding period.* The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 857(b)(7)(B) and this paragraph, a share of real estate investment trust stock has been held for a period of less than 31 days. In applying those rules, however, "30 days" shall be substituted for the number of days specified in subparagraph (B) of such section.

(3) *Illustration.* The application of section 857(b)(7) and this paragraph may be illustrated by the following example:

Example. On December 15, 1961, A purchased a share of stock in the S Real Estate Investment Trust for $20. The S trust declared a capital gains dividend of $2 per share to shareholders of record on December 31, 1961. A, therefore, received a capital gain dividend of $2 which, pursuant to section 857(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than six months. On January 5, 1962, A sold his share of stock in the S trust for $17.50, which sale resulted in a loss of $2.50. Under section 857(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than six months.

(d) *Dividend received credit, exclusion, and deduction not allowed.* Any dividend received from a real estate investment trust which, for the taxable year to which the dividend relates, is a qualified real estate investment trust, shall not be eligible for the dividend received credit (for dividends received on or before December 31, 1964) under section 34(a), the dividend received exclusion under section 116, or the dividend received deduction under section 243.

(e) *Definition of capital gain dividend.* (1)(i) A capital gain dividend, as defined in section 857(b)(3)(C), is any dividend or part thereof which is designated by a real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders within the period specified in section 857(b)(3)(C) and paragraph (f) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858) is greater than the net capital gain of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate of the amount so designated. For example, a real estate investment trust making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1961, that $200,000 of a distribution of $500,000 made December 15, 1961, constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the net capital gain of the taxable year and the net capital gain was $100,000 instead of $200,000. In such case, each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(ii) For purposes of section 857(b)(3)(C) and this paragraph, the net capital gain for a taxable year ending after October 4, 1976, is deemed not to exceed the real estate investment trust taxable income determined by taking into account the net operating loss deduction for the taxable year but not the deduction for dividends paid. See example (2) in § 1.172-5(a)(5).

(2) In the case of capital gain dividends designated with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858), the real estate investment trust must include in its written notice designating the capital gain dividend a statement showing the shareholder's proportionate share of such dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d) (1) or (2), the real estate investment trust shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains which are not described in section 1201(d) (1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d) (1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the trust's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every real estate investment trust shall keep a record of the proportion of each capital gain divided (to which this subparagraph applies) which is gain described in section 1201(d) (1) or (2).

(f) *Mailing of written notice to shareholders*—(1) *General rule.* Except as provided in paragraph (f)(2) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 30 days after the close of the taxable year of the real estate investment trust.

(2) *Net capital gain resulting from a determination.* If, as a result of a determination (as defined in section 859(c)), occurring after October 4, 1976, there is an increase in the amount by which the net capital gain exceeds the deduction for dividends paid (determined with reference to capital gains dividends only) for the taxable year, then a real estate investment trust may designate a dividend (or part thereof) as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The

designation may be made with respect to a dividend (or part thereof) paid during the taxable year to which the determination applies (including a dividend considered as paid during the taxable year pursuant to section 858). A deficiency dividend (as defined in section 859(d)), or a part thereof, that is paid with respect to the taxable year also may be designated as a capital gain dividend by the real estate investment trust (or by the acquiring corporation to which section 381(c)(25) applies) before the expiration of the 120-day period immediately following the determination. However, the aggregate amount of the dividends (or parts thereof) that may be designated as capital gain dividends after the date of the determination shall not exceed the amount of the increase in the excess of the net capital gain over the deduction for dividends paid (determined with reference to capital gains dividends only) that results from the determination. The date of a determination shall be established in accordance with § 1.859-2(b)(1).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 7337, 39 FR 44974, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279, and 11283, Feb. 6, 1981]

§ 1.857-7 Earnings and profits of a real estate investment trust.

(a) Any real estate investment trust whether or not such trust meets the requirements of section 857(a) and paragraph (a) of § 1.857-1 for any taxable year beginning after December 31, 1960 shall apply paragraph (b) of this section in computing its earnings and profits for such taxable year.

(b) In the determination of the earnings and profits of a real estate investment trust, section 857(d) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a trust would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a real estate investment trust would be $500,000. If the real estate investment trust had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the trust would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year. For purposes of section 857(d) and this section, if an amount equal to any net loss derived from prohibited transactions is included in real estate investment trust taxable income pursuant to section 857(b)(2)(F), that amount shall be considered to be an amount which is not allowable as a deduction in computing taxable income for the taxable year. The earnings and profits for the taxable year (but not the accumulated earnings and profits) shall not be considered to be less than (i) in the case of a taxable year ending before October 5, 1976, the amount (if any) of the net capital gain for the taxable year, or (ii) in the case of a taxable year ending after December 31, 1973, the amount (if any), of the excess of the net income from foreclosure property for the taxable year over the tax imposed thereon by section 857(b)(4)(A).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857-8 Records to be kept by a real estate investment trust.

(a) *In general.* Under section 857(a)(2) a real estate investment trust is required to keep such records as will disclose the actual ownership of its outstanding stock. Thus, every real estate investment trust shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from its shareholders. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) *Actual owner of stock.* The actual owner of stock of a real estate investment trust is the person who is required to include in gross income in his return the dividends received on the stock. Generally, such person is the shareholder of record of the real estate investment trust. However, where the shareholder of record is not the actual owner of the stock, the stockholding record of the real estate investment trust may not disclose the actual ownership of such stock. Accordingly, the real estate investment trust shall demand written statements from shareholders of record disclosing the actual owners of stock as required in paragraph (d) of this section.

(c) *Stock ownership for personal holding company determination.* For the purpose of determining under section 856(a)(6) whether a trust, claiming to be a real estate investment trust, is a personal holding company, the permanent records of the trust shall show the maximum number of shares of the trust (including the number and face value of securities convertible into stock of the trust) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the trust's taxable year, as provided in section 544.

(d) *Statements to be demanded from shareholders.* The information required by paragraphs (b) and (c) of this section shall be set forth in written statements which shall be demanded from shareholders of record as follows:

(1) In the case of a trust having 2,000 or more shareholders of record of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a trust having less than 2,000 and more than 200 shareholders of record of its stock on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a trust having 200 or less shareholders of record of its stock on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

(e) *Demands for statements.* The written statements from shareholders of record shall be demanded by the real estate investment trust in accordance with paragraph (d) of this section within 30 days after the close of the real estate investment trust's taxable year (or before June 1, 1962, whichever is later). When making demand for such written statements, the trust shall inform each such shareholder of his duty to submit at the time he files his income tax return (or before July 1, 1962, whichever is later) the statements which are required by § 1.857-9 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with the trust's demand for statements under this section shall be maintained as a part of the trust's records required by this section. A trust which fails to keep such records to show, to the extent required by this section, the actual ownership of its outstanding stock shall be taxable as an ordinary corporation and not as a real estate investment trust.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4088, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857-9 Information required in returns of shareholders.

(a) *In general.* Any person who fails or refuses to submit to a real estate investment trust the written statements required under § 1.857-8 to be demanded by such trust from its shareholders of record shall submit at the time he files his income tax return for his taxable year which ends with, or includes, the last day of the trust's taxable year (or before July 1, 1962, whichever is later) a statement setting forth the information required by this section.

(b) *Information required*—(1) *Shareholder of record not actual owner.* In the case of any person holding shares of stock in any trust claiming to be a real estate investment trust who is not the actual owner of such stock, the name and address of each actual owner, the number of shares owned by each actual owner at any time during such person's taxable year, and the amount of dividends belonging to each actual owner.

(2) *Actual owner of shares.* In the case of an actual owner of shares of stock in any trust claiming to be a real estate investment trust—

(i) The name and address of each such trust, the number of shares actually owned by him at any and all times during his taxable year, and the amount of dividends from each such trust received during his taxable year;

(ii) If shares of any such trust were acquired or disposed of during such person's taxable year, the name and address of the trust, the number of shares acquired or disposed of, the dates of acquisition or disposition, and the names and addresses of the persons from whom such shares were acquired or to whom they were transferred;

(iii) If any shares of stock (including securities convertible into stock) of any such trust are also owned by any member of such person's family (as defined in section 544(a)(2)), or by any of his partners, the name and address of the trust, the names and addresses of such members of his family and his partners, and the number of shares owned by each such member of his family or partner at any and all times during such person's taxable year; and

(iv) The names and addresses of any corporation, partnership, association, or trust, in which such person had a beneficial interest of 10 percent or more at any time during his taxable year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962, as amended by T.D. 6628, 27 FR 12794, Dec. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857-10 Information returns.

Nothing in §§ 1.857-8 and 1.857-9 shall be construed to relieve a real estate investment trust or its shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.858-1 Dividends paid by a real estate investment trust after close of taxable year.

(a) *General rule.* Under section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year. The dividend is taken into account in determining the deduction for dividends paid for the taxable year in which it is treated as paid. The dividend may be an ordinary dividend or, subject to the requirements of sections 857(b)(3)(C) and 858(c), a capital gain dividend. The trust may make the dividend declaration required by section 858(a)(1) either before or after the close of the taxable year as long as the declaration is made before the time prescribed by law for filing its return for the taxable year (including the period of any extension of time granted for filing the return).

(b) *Election*—(1) *Method of making election.* The election must be made in the return filed by the trust for the taxable year. The election shall be made by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the taxable year of the trust in computing its real estate investment trust taxable income and, if applicable, the alternative tax imposed by section 857(b)(3)(A). (In the case of an election with respect to a taxable year ending before October 5, 1976, if the dividend (or portion thereof) to which the election is to apply is a capital gain dividend, the trust shall treat the dividend as paid during such taxable year in computing the amount of capital gains dividends paid during the taxable year.) In the case of an election with respect to a taxable year beginning after October 4, 1976, the trust must also specify in its return (or in a statement attached to its return) the exact dollar amount that is to be treated as having been paid during the taxable year.

(2) *Limitation based on earnings and profits.* The election provided in section 858(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and 1.857-7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year. For purposes of the preceding sentence, deficiency dividends and distributions with respect to which an election has been made for a prior year under section 858(a) are disregarded in determining the total amount of distributions out of earnings and profits actually made during the taxable year. The dividend or portion thereof, with respect to which the real estate investment trust has made a valid election under section 858(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(3) *Additional limitation based on amount specified.* The amount treated under section 858(a) as having been paid in a taxable year beginning after October 4, 1976, cannot exceed the lesser of (i) the dollar amount specified by the trust in its return (or a statement attached thereto) in making the election or (ii) the amount allowable under the limitation prescribed in paragraph (b)(2) of this section.

(4) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 858(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.* Under section 858(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includable in the gross income of the shareholders of the real estate investment trust for the taxable year in which the dividend is received by them.

(d) *Illustrations.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). The X Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1961 of $100,000. During that year the trust distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1962, the trust declared a dividend of $37,000 payable to shareholders on March 20, 1962. Such dividend consisted of the first regular quarterly dividend for 1962 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1961 which was not distributed in 1961. On March 15, 1962, the X Trust filed its Federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1962, as having been paid during the taxable year 1961. Assuming that the X Trust actually distributed the entire amount of the dividend of $37,000 on March 20, 1962, an amount equal to $12,000 thereof will be treated for the purposes of section 857(a) as having been paid during the taxable year 1961. Upon distribution of such dividend the trust becomes a qualified real estate investment trust for the taxable year 1961. Such amount ($12,000) will be considered by the X Trust as a distribution out of the earnings and profits for the taxable year 1961, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them. However, assuming that the X Trust is not a qualified real estate investment trust for the calendar year 1962, nevertheless, the $12,000 portion of the dividend (paid on March 20, 1962) which the trust elected to relate to the calendar year 1961, will not qualify as a dividend for purposes of section 34, 116, or 243.

Example (2). The Y Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1964 of $100,000, and for 1965 taxable income (and earnings and profits) of $125,000. On January 1, 1964, the trust had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1964 the trust distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1965, the trust declared a dividend of $65,000 payable to shareholders on March 31, 1965. On March 15, 1965, the Y Trust filed its Federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1965, as a dividend paid by it during the taxable year 1964. On March 31, 1965, the Y Trust distributed the entire amount of the dividend of $65,000 declared on March 5, 1965. The election under section 858(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1964 ($100,000 earnings and profits less $85,000 distributed during 1964). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1965, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Trust out of earnings and profits for the taxable year 1965. Assuming that the only other distribution by the Y Trust during 1965 was a distribution of $75,000 paid as a dividend on October 31, 1965, the total amount of the distribution of $65,000 paid on March 31, 1965, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Trust will treat the amount of $15,000 as a distribution of the earnings or profits of the trust for the taxable year 1964, and the remaining $50,000 as a distribution of the earnings or profits for the year 1965. The distribution of $75,000 on October 31, 1966, is, of course, a taxable dividend out of the earnings and profits for the year 1965.

Example (3). Assume the facts are the same as in example (2), except that the taxable years involved are calendar years 1977 and 1978, and Y Trust specified in its Federal income tax return for 1977 that the dollar amount of $40,000 of the $65,000 distribution payable to shareholders on March 31, 1978, is to be treated as having been paid in 1977. The result will be the same as in example (2), since the amount of the undistributed earnings and profits for 1977 is less than the $40,000 amount specified by Y Trust in making its election. Accordingly, the election is valid only to the extent of $15,000. Y Trust will treat the amount of $15,000 as a distribution, in 1977, of earnings and profits of the trust for the taxable year 1977 and the remaining $50,000 as a distribution, in 1978, of the earnings and profits for 1978.

(e) *Notice to shareholders.* Section 858(c) provides that, in the case of dividends with respect to which a real estate investment trust has made an election under section 858(a), any notice to shareholders required under part II, subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 30 days after the close of the taxable year in which the distribution is made. Thus, the notice requirement of section

857(b)(3)(C) and paragraph (f) of § 1.857-6 with respect to capital gains dividends may be satisfied with respect to amounts to which section 858(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 30 days after the close of the taxable year in which the distribution is made. If the notice under section 858(c) reltes to an election with respect to any capital gains dividends, such capital gains dividends shall be aggregated by the real estate investment trust with the designated capital gains dividends actually paid during the taxable year to which the election applies (not including deficiency dividends or dividends with respect to which an election has been made for a prior taxable year under section 858) to determine whether the aggregate of the designated capital gains dividends with respect to such taxable year exceeds the net capital gain of the trust. See section 857(b)(3)(C) and paragraph (f) of § 1.857-6.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 6598, 27 FR 4089, Apr. 28, 1962, as amended by T.D. 7767, 46 FR 11279, Feb. 6, 1981]

§ 1.859-1 Deficiency dividends.

Section 859 provides a method by which a real estate investment trust may be relieved from the payment of a deficiency in (or be allowed a credit or refund with respect to) the tax imposed by section 857(b) (1) or (3), the minimum tax on tax preferences imposed by section 56, or, in the case of a real estate investment trust that fails the distribution requirements of section 857(a)(1), the corporate income tax imposed by section 11(a) or 1201(a). The method provided by section 859 is to allow an additional deduction for a dividend distribution (which meets the requirements of sections 859 and 1.859-2) in computing the deduction for dividends paid for the taxable year for which the deficiency is determined. A deficiency dividend may be an ordinary dividend, or, subject to the limitations of sections 857(b)(3)(C) and 859(d)(2)(B), may be a capital gain dividend.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11280, Feb. 6, 1981]

§ 1.859-2 Requirements for deficiency dividends.

(a) *In general.* A real estate investment trust is allowed a deduction for a deficiency dividend only if there is a determination (as defined in section 859(c) and paragraph (b)(1) of this section) occurring after October 4, 1976, that results in an adjustment (as defined in section 859(b)(1)) for the taxable year with respect to which the deficiency dividend is paid. The deficiency dividend must be paid on, or within 90 days after, the date of the determination and before the filing of a claim under section 859(e) and paragraph (b)(2) of this section. This claim must be filed within 120 days after the date of the determination. The deficiency dividend must be a distribution of property (including money) that would have been properly taken into account in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for tax resulting from the determination exists, if the money or other property had been distributed during that taxable year. Thus, for purposes of section 859(d), where the distribution would have been a dividend within the meaning of sections 316(a) and 1.316-1, if it had been made during the taxable year with respect to which the determination applies, the distribution will meet the requirements of section 562(a) (relating to rules applicable in determining dividends eligible for the deduction for dividends paid), even though the distributing corporation, trust, or association has no current or accumulated earnings and profits for the taxable year in which the distribution is actually made. The amount of the distribution shall be determined under section 301 as of the date of the distribution. The amount of the deduction is subject to the limitations set forth in sections 562 and 859(d)(2) and the regulations thereunder. Thus, in the case of a distribution to an individual shareholder of property (other than money) which has a fair market value in excess of the adjusted basis of the property in the hands of the distributing corporation, trust, or association at the time of the distribution, the amount of the deficiency dividend, for purposes of section 316(b)(3), shall be the amount which would have been a dividend if the property (taking into account its fair market value as of the date of the distribution) had been distributed during the taxable year with respect to which the determination applies, even though the deduction for dividends paid is limited, under § 1.562-1(a), to the adjusted basis of the property. The corporation, trust, or association that pays the deficiency dividends does not have to be a qualified real estate investment trust at the time of payment.

(b) *Determination and claim for deduction*—(1) *Determination.* For purposes of applying section 859(c) and this section, the following rules shall apply:

(i) The date of determination by a decision of the United States Tax Court is the date upon which the decision becomes final, as prescribed in section 7481.

(ii) The date upon which a judgment of a court becomes final, which is the date of the determination in such cases, must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no appeal is duly taken within that time. A judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no petition is duly filed within that time.

(iii) The date of determination by a closing agreement, made under section 7121, is the date the agreement is approved by the Commissioner.

(iv) A determination under section 859(c)(3) may be made by an agreement signed by the district director or another official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the amount, if any, of each adjustment described in subparagraphs (A), (B), and (C) of section 859(b)(1) for the taxable year, the amount of the liability for any tax imposed by section 11(a), 56(a), 857(b)(1), 857(b)(3)(A) or 1201(a) for the taxable year, and the amount of the limitation (determined under section 859(d)(2)) on the amount of deficiency dividends that can qualify as capital gain dividends and ordinary dividends, respectively, for the taxable year. An agreement under this subdivision which is signed by the district director (or other delegate) shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration shall be treated as the date of determination. If certified mail is used, the date of the postmark on the sender's receipt shall be treated as the date of determination. However, if a dividend is paid by the taxpayer before the registration or postmark date, but on or after the date the agreement is signed by the district director (or other delegate), the date of determination shall be the date of signing.

(2) *Claim for deduction.* A claim for deduction for a deficiency dividend shall be made, with the requisite declaration, on Form 976 and shall contain the following information:

(i) The name, address, and taxpayer identification number of the corporation, trust, or association;

(ii) The amount of the deficiency and the taxable year or years involved;

(iii) The amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof;

(iv) A statement as to how the deficiency was established (i.e., by an agreement under section 859(c)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment);

(v) Any date or other information with respect to the determination that is required by Form 976;

(vi) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(vii) The amount claimed as a deduction for deficiency dividends;

(viii) If the amount claimed as a deduction for deficiency dividends includes any amount designated (or to be designated) as capital gain dividends, the amount of capital gain dividends for which a deficiency dividend deduction is claimed; and

(ix) Any other information required by the claim form.

A certified copy of the resolution of the trustees, directors, or other authority, authorizing the payment of the dividend with respect to which the claim is filed must accompany the claim. Also, any copy of a court decision, judgment, agreement, or other document required by Form 976 must accompany the claim. The claim, together with the accompanying documents, shall be filed with the district director, or director of the internal revenue service center, with whom the income tax return for the taxable year with respect to which the determination applies was filed. In the event that the determination is an agreement with the district director (or his delegate) described in section 859(c)(3) and paragraph (b)(1)(iv) of this section, the claim may be filed with the district director with whom (or pursuant to whose delegation) the agreement was made.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11280, Feb. 6, 1981]

§ 1.859-3 Intrerest and additions to tax.

(a) *In general.* If a real estate investment trust is allowed a deduction for deficiency dividends, under section 859(b)(2) the tax imposed on the trust by chapter 1 of the Code (computed by taking into account the deduction) for the taxable year with respect to which the deduction is allowed is deemed to be increased by an amount equal to the amount of the deduction. This deemed increase in tax, however, applies solely for purposes of determining the liability of the trust for interest under subchapter A of chapter 67 of the Code and for additions to tax and additional amounts under chapter 68 of the Code. For purposes of applying subchapter A of chapter 67 and chapter 68, the last date prescribed for payment of the deemed increase in tax shall be considered to be the last date prescribed for the payment of tax (determined in the manner provided in section 6601(b)) for the taxable year for which the deduction for deficiency dividends is allowed. The deemed increase in tax shall be considered to be paid as of the date that the claim for the deficiency dividend deduction described in section 859(e) and § 1.859-2(b)(2) is filed.

(b) *Overpayments of tax.* If a real estate investment trust is entitled to a credit or refund of an overpayment of the tax imposed by chapter 1 of the Code for the taxable year for which the deficiency dividend deduction is allowed, then, for purposes of computing interest, additions to tax, and additional amounts, the payment (or payments) that result in the overpayment and that precede the filing of the claim described in section 859(e) will be applied against and reduce the increase in tax that is deemed to occur under section 859(b)(2).

(c) *Example.* This section may be illustrated by the following examples:

Example (1). Corporation X is a real estate investment trust that files its income tax return on a calendar year basis. For its taxable year 1977, corporation X receives an extension of time until June 15, 1978, to file its income tax return. Corporation X does not elect to pay any tax due in installments. On its 1977 income tax return, filed on May 15, 1978, corporation X reports real estate investment trust taxable income (computed without regard to the dividends paid deduction) of $100, a dividends paid deduction of $100, and no tax liability. Following an examination of corporation X's 1977 return, the district director and corporation X enter into an agreement which constitutes a determination under section 859(c)(3). Under the determination (which is dated November 1, 1979), the real estate investment trust taxable income of corporation X (computed without the dividends paid deduction) is increased by $20 to $120. Thus, taking into account the $100 of dividends paid in 1977, corporation X has undistributed real estate investment trust taxable income of $20 as a result of the determination. Corporation X pays a dividend of $20 on November 10, 1979, files a claim for a deficiency dividend deduction of $20 pursuant to section 859(e) with respect to such dividend on November 15, 1979, and is allowed a deficiency dividend deduction of $20 with respect to its taxable year 1977. Corporation X, after taking into account the deduction for deficiency dividends, has no real estate investment trust taxable income and has met the distribution requirements of section 857(a)(1). However, for purposes of section 6601 (relating to interest on underpayment of tax) the tax imposed by chapter 1 of the Code on corporation X for the taxable year 1977 is deemed to be increased by $20 (the amount of the deficiency dividend deduction allowed with respect to the taxable year 1977), and the last date prescribed for payment of the tax is March 15, 1978 (the due date of the return determined without regard to any extension of time). The tax of $20 is deemed to be paid on November 15, 1979, the date the claim for the deficiency dividend deduction is filed pursuant to section 859(e). Thus, corporation X is liable for interest on $20, at the rate established under section 6621, for the period from March 15, 1978, to November 15, 1979. Also for purposes of determining whether corporation X is liable for any addition to tax or additional amount imposed by chapter 68 of the Code (including the penalty prescribed by section 6697) the amount of tax imposed on corporation X by chapter 1 of the Code is deemed to be increased by $20 (the amount of the deficiency dividend deduction allowed), the last date prescribed for payment of such tax is March 15, 1978, and the tax of $20 is deemed to be paid on November 15, 1979. Corporation X, however, is not subject to interest and penalties with respect to the amount of any tax for which it would have been liable under section 11(a), 56(a), 1201(a), or 857(b) had it not been allowed the $20 deduction for deficiency dividends.

Example (2). Assume the facts are the same as in example (1) except that the district director, upon examination of corporation X's income tax return, asserts a deficiency in income tax of $4, based on an asserted increase of $10 in real estate investment trust taxable income, and no agreement is entered into between the parties. Corporation X pays the $4 on June 1, 1979, and files suit for refund in the United States District Court. The District Court in a decision which becomes final on November 1, 1980, holds that corporation X did fail to report $10 of real estate investment trust taxable income and is not entitled to any refund. (No other item of income or deduction is in issue.) Corporation X pays a dividend of $10 on November 10, 1980, files a claim for a deficiency dividend deduction of $10 with respect to such dividend on November 15, 1980, and is allowed a deficiency dividend deduction of $10 for 1977. Assume further that $4 is refunded to corporation X on December 31, 1980, as the result of the $10 deficiency dividend deduction being allowed. Also assume that any assessable penalties, additional amounts, and additions to tax (including the penalty imposed by section 6697) for which corporation X is liable are paid within 10 days of notice and demand, so that no interest is imposed on such penalties, etc. The liability of corporation X for interest for the period March 15, 1978, to June 1, 1979, will be determined with respect to $10 (the amount of the deficiency dividend deduction allowed). The liability of corporation X for interest for the period June 1, 1979 to November 15, 1980, will be determined with respect to $6 ($10 minus the $4 payment). Corporation X will be entitled to interest on the $4 overpayment for the period described in section 6611(b)(2), beginning on November 15, 1980.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11281, Feb. 6, 1981]

§ 1.859-4 Claim for credit or refund.

In a case where the allowance of a deduction for a deficiency dividend results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X in addition to the claim for the deduction required under section 859(e). The credit or refund will be allowed as if on the date of the determination two years remained before the expiration of the period of limitations on the filing of claim for refund for the taxable year to which the overpayment relates.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11282, Feb. 6, 1981]

§ 1.860-1 Adoption of or change in annual accounting period.

Under section 860, a real estate investment trust may not change to or adopt any taxable year beginning after October 4, 1976, other than the calendar year.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. (856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749, 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11282, Feb. 6, 1981]

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

§ 1.861-1 Income from sources within the United States.

(a) *Categories of income.* Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861-2 to 1.861-7, inclusive, and § 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.861-8 and 1.863-1.

(2) *Without the United States.* The gross income from sources without the United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.862-1 and 1.863-1. The taxable income from sources without

the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862-1 and 1.863-1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863-2 to 1.863-5, inclusive.

(4) *Exception.* An owner of certain aircraft or vessels may elect to treat income in respect of the lease of these aircraft or vessels or gains with respect of their disposition as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861-9.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States, together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7635, 44 FR 46457, Aug. 8, 1979]

§ 1.861-2 Interest.

(a) *In general.* (1) Gross income consisting of interest from the United States or any agency or instrumentality thereof (other than a possession of the United States or an agency or instrumentality of a possession), a State or any political subdivision thereof, or the District of Columbia, and interest from a resident of the United States on a bond, note, or other interest-bearing obligation issued or assumed by such person shall be treated as income from sources within the United States. Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof, or the District of Columbia. Interest other than that described in this paragraph is not to be treated as income from sources within the United States.

(2) The term "resident of the United States", as used in this paragraph, includes (i) an individual who at the time of payment of the interest is a resident of the United States, (ii) a domestic corporation, (iii) a domestic partnership which at any time during its taxable year is engaged in trade or business in the United States, or (iv) a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States.

(3) The method by which, or the place where, payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.

(4) For purposes of this section, the term "interest" includes all amounts treated as interest under section 483, and the regulations thereunder. It also includes original issue discount, as defined in section 1232(b)(1), whether or not the underlying bond, debenture, note, certificate, or other evidence of indebtedness is a capital asset in the hands of the taxpayer within the meaning of section 1221.

(5) If interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident's capacity as a guarantor of the obligation of the resident, the interest will be treated as income from sources within the United States.

(6) In the case of interest received by a nonresident alien individual or foreign corporation this paragraph (a) applies whether or not the interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual or corporation.

(b) *Interest not derived from U.S. sources.* Notwithstanding paragraph (a) of this section, interest shall be treated as income from sources without the United States to the extent provided by subparagraphs (A) through (H), of section 861(a)(1) and by the following subparagraphs of this paragraph.

(1) *Interest on bank deposits and on similar amounts.* (i) Interest paid or credited before January 1, 1977, to a nonresident alien individual or foreign corporation on—

(*a*) Deposits with persons, including citizens of the United States or alien individuals and foreign or domestic partnerships or corporations, carrying on the banking business in the United States,

(*b*) Deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, or

(*c*) Amounts held by an insurance company under an agreement to pay interest thereon,

shall be treated as income from sources without the United States if such interest is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation. If such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such nonresident alien individual or foreign corporation, it shall be treated as income from sources within the United States under paragraph (a) of this section unless it is treated as income from sources without the United States under another subparagraph of this paragraph. For a special rule for determining whether such interest is effectively connected for the taxable year with the conduct of a trade or business in the United States, see paragraph (c)(1)(ii) or § 1.864-4.

(ii) Paragraph (b)(1)(i)(*b*) of this section applies to interest on deposits or withdrawable accounts described therein only to the extent that the interest paid or credited by the savings institution described therein is deductible under section 591 in determining the taxable income of such institution; and, for this purpose, whether an amount is deductible under section 591 shall be determined without regard to section 265, relating to deductions allocable to tax-exempt income. Thus, for example, such subdivision does not apply to amounts paid by a savings and loan or similar association on or with respect to its nonwithdrawable capital stock or on or with respect to funds held in restricted accounts which represent a proprietary interest in such association. Paragraph (b)(1)(i)(*b*) of this section also applies to so-called dividends paid or credited on deposits or withdrawable accounts if such dividends are deductible under section 591 without reference to section 265.

(iii) For purposes of paragraph (b)(1)(i)(*c*) of this section, amounts held by an insurance company under an agreement to pay interest thereon include policyholder dividends left with the company to accumulate, prepaid insurance premiums, proceeds of policies left on deposit with the company, and overcharges of premiums. Such subdivision does not apply to (*a*) the so-called "interest element" in the case of annuity or installment payments under life insurance or endowment contracts or (*b*) interest paid by an insurance company to its creditors on notes, bonds, or similar evidences of indebtedness, if the debtor-creditor relationship does not arise by virtue of a contract of insurance with the insurance company.

(iv) For purposes of paragraph (b)(1)(i) of this section, interest received by a partnership shall be treated as received by each partner of such partnership to the extent of his distributive share of such item.

(2) *Interest from a resident alien individual or domestic corporation deriving substantial income from sources without the United States.* In-

terest received from a resident alien individual or a domestic corporation shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that less than 20 percent of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as determined under the provisions of sections 861 to 863, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such individual or corporation preceding its taxable year in which such interest is paid or credited, or for such part of such period as may be applicable. If 20 percent or more of the gross income from all sources of such individual or corporation has been derived from sources within the United States, as so determined, for such 3-year period (or part thereof), the entire amount of the interest from such individual or corporation shall be treated as income from sources within the United States.

(3) *Interest from a foreign corporation not deriving major portion of its income from a U.S. business.* (i) Interest from a foreign corporation which, at any time during the taxable year, is engaged in trade or business in the United States shall be treated as income from sources without the United States when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that (*a*) less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864-3, or (*b*) such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct of a trade or business in the United States.

(ii) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, see section 861(a)(1)(D) and paragraph (c)(1) of this section for determining the portion of interest from such corporation which is treated as income from sources within the United States.

(iii) For purposes of this paragraph the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e) and the regulations thereunder, is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(iv) This paragraph does not apply to interest paid or credited after December 31, 1969, by a branch in the United States of a foreign corporation if, at the time of payment or crediting, such branch is engaged in the commercial banking business in the United States; furthermore, such interest is treated under paragraph (a) of this section as income from sources within the United States unless it is treated as income from sources without the United States under paragraph (b) (1) or (4) of this section.

(4) *Bankers' acceptances.* Interest derived by a foreign central bank of issue from bankers' acceptances shall be treated as income from sources without the United States. For this purpose, a foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose laws it is organized.

(5) *Foreign banking branch of a domestic corporation or partnership.* Interest paid or credited on deposits with a branch outside the United States (as defined in section 7701(a)(9)) of a domestic corporation or of a domestic partnership shall be treated as income from sources without the United States, if, at the time

of payment or crediting, such branch is engaged in the commercial banking business. For purposes of applying this paragraph, it is immaterial (i) whether the domestic corporation or domestic partnership is carrying on a banking business in the United States, (ii) whether the recipient of the interest is a citizen or resident of the United States, a foreign corporation, or a foreign partnership, (iii) whether the interest is effectively connected with the conduct of a trade or business in the United States by the recipient, or (iv) whether the deposits with the branch located outside the United States are payable in the currency of a foreign country. Notwithstanding the provisions of § 1.863-6, interest to which this paragraph applies shall be treated as income from sources within the foreign country, possession of the United States, or other territory in which the branch is located.

(6) *Section 4912(c) debt obligations*—(i) *In general.* Under section 861(a)(1)(G), interest on a debt obligation shall not be treated as income from sources within the United States if—

(*a*) The debt obligation was part of an issue of debt obligations with respect to which an election has been made under section 4912(c) (relating to the treatment of such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax),

(*b*) The debt obligation had a maturity not exceeding 15 years (within the meaning of paragraph (b)(6)(ii) of this section) on the date it is originally issued or on the date it is treated under section 4912(c)(2) as issued by reason of being assumed by a certain domestic corporation,

(*c*) The debt obligation, when originally issued, was purchased by one or more underwriters (within the meaning of paragraph (b)(6)(iii) of this section) with a view to distribution through resale (within the meaning of paragraph (b)(6)(iv) of this section), and

(*d*) The interest on the debt obligation is attributable to periods after the effective date of an election under section 4912(c) to treat such debt obligations as debt obligations of a foreign obligor for purposes of the interest equalization tax.

(ii) *Maturity not exceeding 15 years.* The date the debt obligation is issued or treated as issued is not included in the 15 year computation, but the date of maturity of the debt, obligation is included in such computation.

(iii) *Purchased by one or more underwriters.* For purposes of this paragraph, the debt obligation when originally issued will not be treated as purchased by one or more underwriters unless the underwriter purchases the debt obligation for his own account and bears the risk of gain or loss on resale. Thus, for example, a debt obligation, when originally issued, will not be treated as purchased by one or more underwriters if the underwriter acts only in the capacity of an agent of the issuer. Neither will a debt obligation, when originally issued, be treated as purchased by one or more underwriters if the agreement between the underwriter and issuer is merely for a "best efforts" underwriting, for the purchase by the underwriter of all or a portion of the debt obligations remaining unsold at the expiration of a fixed period of time, or for any other arrangement under the terms of which the debt obligations are not purchased by the underwriter with a view to distribution through resale. The fact that an underwriter is related to the issuer will not prevent the underwriter from meeting the requirements of this paragraph. In determining whether a related underwriter meets the requirements of this paragraph consideration shall be given to whether the purchase by the underwriter of the debt obligation from the issuer for resale was effected by a transaction subject to conditions similar to those which would have been imposed between independent persons.

(iv) *With a view to distribution through resale.* (*a*) An underwriter who purchased a debt obligation shall be deemed to have purchased it with a view to distribution through resale if the requirements of paragraph (b)(6)(iv) (*b*) or (*c*) of this section are met.

(*b*) The requirements of this paragraph (*b*) is that—

(*1*) The debt obligation is registered, approved, or listed for trading on one or more foreign securities exchanges or foreign established securities markets within 4 months after the date on which the underwriter purchases the debt obligation, or by the date of the first interest payment on the debt obligation, whichever is later, or

(*2*) The debt obligation, or any substantial portion of the issue of which the debt obligation is a part, is actually traded on one or more foreign securities markets on or within 15 calendar days after the date on which the underwriter purchases the debt obligation.

For purposes of this paragraph (b)(6)(iv), a foreign established securities market includes any foreign over-the-counter market as reflected by the existence of an inter-dealer quotation system for regularly disseminating to brokers and dealers quotations of obligations by identified brokers or dealers, other than quotations prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(*c*) The requirements of this paragraph (*c*) are that, except as provided in paragraph (b)(6)(iv)(*d*) of this section, the underwriter is under no written or implied restriction imposed by the issuer with respect to whom he may resell the debt obligation and either—

(*1*) Within 30 calendar days after he purchased the debt obligation the underwriter or underwriters either (*i*) sold it or (*ii*) sold at least 95 percent of the face amount of the issue of which the debt obligation is a part, or

(*2*)(*i*) The debt obligation is evidenced by an instrument which, under the laws of the jurisdiction in which it is issued, is either negotiable or transferable by assignment (whether or not it is registered for trading), and (*ii*) it appears from all the relevant facts and circumstances, including any written statements or assurances made by the purchasing underwriter or underwriters, that such debt obligation was purchased with a view to distribution through resale.

(*d*) The requirements of paragraph (b)(6)(iv)(*c*) of this paragraph may be met whether or not the underwriter is restricted from reselling the debt obligations—

(*1*) To a United States person (as defined in section 7701(a)(30)) or

(*2*) To any particular person or persons pursuant to a restriction imposed by, or required to be met in order to comply with, United States or foreign securities or other law.

(v) *Statement with return.* Any taxpayer who is required to file a tax return and who excludes from gross income interest of the type specified in this subparagraph must comply with the requirements of paragraph (d) of this section.

(vi) *Effect of termination of IET.* If the interest equalization tax expires, the provisions of section 861(a)(1)(G) and this subparagraph shall apply to interest paid on debt obligations only with respect to which a section 4912(c) election was made.

(vii) *Definition of term underwriter.* For purposes of section 861(a)(1)(G) and this paragraph, the term "underwriter" shall mean any underwriter as defined in section 4919(c)(1).

(c) *Special rules*—(1) *Proration of interest from a foreign corporation deriving major portion of its income from a U.S. business.* If, after applying the first sentence of paragraph (b)(3) of this section to interest to which that paragraph applies, it is determined that the interest may not be treated as income from sources without the United States, the amount of the interest from the foreign corporation which at some time during the taxable year is engaged in trade or business in the United States which is to be treated as income from sources within the United States shall be the amount that bears the same ratio to such interest as the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding its taxable year in which such interest is paid or credited (or for such part of such period as the corporation has been in existence) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(2) *Payors having no gross income for period preceding taxable year of payment.* If the resident alien individual, domestic corporation, or foreign corporation, as the case may be, paying interest has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (b) (2) or (3) of this section, or paragraph (c)(1) of this section, the 20-percent test or the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of the payor in which the interest is paid or credited. This paragraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the payor, from the fact that the payor is a corporation which is newly created or organized, or from any other cause.

(3) *Transitional rule.* For purposes of applying paragraph (b)(3) of this section, and paragraph (c)(1) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89-809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business in the United States by such foreign corporation.

(4) *Gross income determinations.* In making determinations under paragraph (b) (2) or (3) of this section, or paragraph (c) (1) or (3) of this section—

(i) The gross income of a domestic corporation or a resident alien individual is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(d) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude an amount of interest from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the obligor of the interest, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the obligor setting forth such information and indicating the amount of interest to be treated as income from sources without the United States may be used for this purpose. See §§ 1.6012-1(b)(1)(i) and 1.6012-2(g)(1)(i).

(e) *Effective date.* This section applies with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.861-2 (Rev. as of Jan. 1, 1972).

[T.D. 7378, 40 FR 45429, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

§ 1.861-3 Dividends.

(a) *General*—(1) *Dividends included in gross income.* Gross income from sources within the United States includes a dividend described in subparagraph (2), (3), (4), or (5) of this paragraph. For purposes of subparagraphs (2), (3), and (4) of this paragraph, the term "dividend" shall have the same meaning as set forth in section 316 and the regulations thereunder. See subparagraph (5) of this paragraph for special rules with respect to certain dividends from a DISC or former DISC.

(2) *Dividend from a domestic corporation.* A dividend described in this subparagraph is a dividend from a domestic corporation other than a domestic corporation entitled to the benefits of section 931, and other than

a domestic corporation less than 20 percent of the gross income of which is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) to have been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividend, or for such part of such period as the corporation has been in existence. See subparagraph (5) of this paragraph for the treatment of certain dividends from a DISC or former DISC.

(3) *Dividend from a foreign corporation*—(i) *In general.* (*a*) A dividend described in this subparagraph is a dividend from a foreign corporation (other than a dividend to which subparagraph (4) of this paragraph applies) unless less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the taxable year in which occurs the declaration of such dividend (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864-3. Thus, no portion of a dividend from a foreign corporation shall be treated as income from sources within the United States under section 861(a)(2)(B) if less than 50 percent of the gross income of such foreign corporation from all sources for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States or if such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct by such corporation of a trade or business in the United States.

(*b*) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, the amount of the dividend which is to be treated as income from sources within the United States under section 861(a)(2)(B) shall be the amount that bears the same ratio to such dividend as the gross income of such foreign corporation for such 3-year period (or part thereof) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(*c*) For purposes of this subdivision (i), the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e), is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(ii) *Rule applicable in applying limitation on amount of foreign tax credit.* For purposes of determining under section 904 the limitation upon the amount of the foreign tax credit—

(*a*) So much of a dividend from a foreign corporation as exceeds (and only to the extent it so exceeds) the amount which is 100/85ths of the amount of the deduction allowable under section 245(a) in respect of such dividend, plus

(*b*) An amount which bears the same proportion to any section 78 dividend to which the dividend from the foreign corporation gives rise as the amount of the excess determined under (*a*) of this subdivision bears to the total amount of the dividend from the foreign corporation,

shall, notwithstanding subdivision (i) of this subparagraph, be treated as income from sources without the United States. This subdivision applies to a dividend for which no dividends-received deduction is allowed under section 245 or for which the 85 percent dividends-received deduction is allowed under section 245(a) but does not apply to a dividend for which a deduction is allowable under section 245(b). All of a dividend for which the 100 percent dividends-received deduction is allowed under section 245(b) shall be treated as income from sources within the United States for purposes of determining under section 904 the limitation upon the amount of the foreign tax credit. If the amount of a distribution of property other than money (constituting a dividend under section 316) is determined by applying section 301(b)(1)(C), such amount must be used as the dividend for purposes of applying (*a*) of this subdivision even though the amount used for purposes of section 245(a) is determined by applying section 301(b)(1)(D). In making determinations under this subdivision, a dividend (other than a section 78 dividend referred to in (*b*) of this subdivision) shall be determined without regard to section 78.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). D, a domestic corporation, owns 80 percent of the outstanding stock of M, a foreign manufacturing corporation. M, which makes its returns on the basis of the calendar year, has earnings and profits of $200,000 for 1971 and 60 percent of its gross income for that year is effectively connected for 1971 with the conduct of a trade or business in the United States. For an uninterrupted period of 36 months ending on December 31, 1970, M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 60 percent of its gross income from all sources for such period. The only distribution by M to D for 1971 is a cash dividend of $100,000; of this amount, $60,000 ($100,000×60%) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and $40,000 ($100,000−$60,000) is treated under § 1.862-1(a)(2) as income from sources without the United States. Accordingly, under section 245(a), D is entitled to a dividends-received deduction of $51,000 ($60,000×85%), and under subdivision (ii) of this subparagraph $40,000 ($100,000−[$51,000×100/85]) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example (2). (a) The facts are the same as in example (1) except that the distribution for 1971 consists of property which has a fair market value of $100,000 and an adjusted basis of $30,000 in M's hands immediately before the distribution. The amount of the dividend under section 316 is $58,000, determined by applying secton 301(b)(1)(C) as follows:

Portion of adjusted basis of property attributable to gross income of M effectively connected for 1971 with conduct of trade or business in United States ($30,000 × 60%)	$18,000
Portion of fair market value of property attributable to gross income of M not effectively connected for 1971 with conduct of trade or business in United States ($100,000 × 40%)	40,000
Total dividend	58,000

(b) Of the total dividend, $34,800 ($58,000×60% (percentage applicable to 3-year period)) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and $23,200 ($58,000×40%) is treated under § 1.862-1(a)(2) as income from sources without the United States. However, by reason of section 245(c) the adjusted basis of the property ($30,000) is used under section 245(a) in determining the dividends-received deduction. Thus, under section 245(a), D is entitled to a dividends-received deduction of $15,300 ($30,000×60%×85%).

(c) Under subdivision (ii) of this subparagraph, the amount of the dividend for purposes of applying (*a*) of that subdivision is the amount ($58,000) determined by applying section 301(b)(1)(C) rather than the amount ($30,000) determined by applying section 301(b)(1)(B). Accordingly, under subdivision (ii) of this subparagraph $40,000 ($58,000−[$15,300×100/85]) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example (3). (a) D, a domestic corporation which makes its returns on the basis of the calendar year, owns 100 percent of the outstanding stock of N, a foreign corporation which is not a less developed country corporation under section 902(d). N, which makes its returns on the basis of the calendar year, has total gross income for 1971 of $100,000, of which $80,000 (including $60,000 from sources within foreign country X) is effectively connected for that year with the conduct of a trade or business in the United States. For 1971 N is assumed to have paid $27,000 of income taxes to country X and to have accumulated profits of $81,000 for purposes of section 902(c)(1)(A). N's accumulated profits in excess of foreign income taxes amount to $54,000. For 1971 D receives a cash dividend of $42,000 from N, which is D's only income for that year.

(b) For 1971 D chooses the benefits of the foreign tax credit under section 901, and as a result is required under section 78 to include in gross income an amount equal to the foreign income taxes of $21,000 ($27,000×$42,000/$54,000) it is deemed to have paid under section 902(a)(1). Thus, assuming no other deductions for the taxable year, D has gross income of $63,000 ($42,000 + $21,000) for 1971 less a dividends-received deduction under section 245(a) of $28,560 ([$42,000 × $80,000/$100,000] × 85%), or taxable income for 1971 of $34,440.

(c) Under subdivision (ii) of this subparagraph, for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit, $12,600 is treated as income from sources without the United States, determined as follows:

Excess of dividend from N over amount which is 100/85ths of amount of sec. 245(a) deduction ($42,000 – [$28,560 × 100/85])	$8,400
Proportionate part of sec. 78 dividend ($21,000 × $8,400/$42,000)	4,200
Taxable income from sources without the United States	12,600

Example (4). A, an individual citizen of the United States who makes his return on the basis of the calendar year, receives in 1971 a cash dividend of $10,000 from M, a foreign corporation, which makes its return on the basis of the calendar year. For the 3-year period ending with 1970 M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 80 percent of its gross income from all sources for such period. Of the total dividend, $8,000 ($10,000 × 80%) is treated under subdivision (i) of this subparagraph as income from sources within the United States and $2,000 ($10,000 – $8,000) is treated under § 1.862-1(a)(2) as income from sources without the United States. Since under section 245 no dividends received-deduction is allowable to an individual, A is entitled under subdivision (ii) of this subparagraph to treat the entire dividend of $10,000 ($10,000 – [$0 × 100/85]) as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

(4) *Dividend from a foreign corporation succeeding to earnings of a domestic corporation.* A dividend described in this subparagraph is a dividend from a foreign corporation, if such dividend is received by a corporation after December 31, 1959, but only to the extent that such dividend is treated by such recipient corporation under the provisions of § 1.243-3 as a dividend from a domestic corporation subject to taxation under chapter 1 of the Code. To the extent that this subparagraph applies to a dividend received from a foreign corporation, subparagraph (3) of this paragraph shall not apply to such dividend.

(5) *Certain dividends from a DISC or former DISC*—(i) *General rule.* A dividend described in this subparagraph is a dividend from a corporation that is a DISC or former DISC (as defined in section 992(a)) other than a dividend that—

(*a*) Is deemed paid by a DISC, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D), and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) to the extent provided in subdivision (iii) of this subparagraph or

(*b*) Reduces under § 1.996-3(b)(3) accumulated DISC income (as defined in subdivision (ii)(*b*) of this subparagraph) to the extend provided in subdivision (iv) of this subparagraph.

Thus, a dividend deemed paid under section 995(b)(1) (A), (B), or (C) (relating to certain deemed distributions in qualified years) will be treated in full as gross income from sources within the United States. To the extent that a dividend from a DISC or former DISC is paid out of other earnings and profits (as defined in § 1.996-3(d)), subparagraph (2) of this paragraph shall apply. To the extent that a dividend from a DISC or former DISC is paid out of previously taxed income (as defined in § 1.996-3(c)), see section 996(a)(3) (relating to the exclusion from gross income of amounts distributed out of previously taxed income). In determining the source of income of certain dividends from a DISC or former DISC, the source of income from any transaction which gives rise to gross receipts (as defined in § 1.993-6), in the hands of the DISC or former DISC, is immaterial.

(ii) *Definitions.* For purposes of this subparagraph, the term—

(*a*) "Dividend from" means any amount actually distributed which is a dividend within the meaning of section 316 (including distributions to meet qualification requirements under section 992(c)) and any amount treated as a distribution taxable as a dividend pursuant to section 995(b) (relating to deemed distributions in qualified years or upon disqualification) or included in gross income as a dividend pursuant to section 995(c) (relating to gain on certain dispositions of stock in a DISC or former DISC), and

(*b*) "Accumulated DISC income" means the amount of accumulated DISC income as of the close of the taxable year immediately preceding the taxable year in which the dividend was made increased by the amount of DISC income for the taxable year in which the dividend was made (as determined under § 1.996-3(b)(2))

(*c*) "Nonqualified export taxable income" means the taxable income of a DISC from any transaction which gives rise to gross receipts (as defined in § 1.993-6) which are not qualified export receipts (as defined in § 1.993-1) other than a transaction giving rise to gain described in section 995(b)(1) (B) or (C).

For purposes of subdivisions (i)(*b*) and (iv) of this subparagraph, if by reason of section 995(c), gain is included in the shareholder's gross income as a dividend, accumulated DISC income shall be treated as if it were reduced under § 1.996-3(b)(3).

(iii) *Determination of source of income for deemed distributions, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F).* (*a*) If for its taxable years a DISC does not have any nonqualified export taxable income, then for such year the entire amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend will be treated as gross income from sources without the United States.

(*b*) If for its taxable year a DISC has any nonqualified export taxable income, then for such year the portion of the amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend that will be treated as income from sources within the United States shall be equal to the amount of such nonqualified export taxable income multiplied by the following fraction. The numerator of the fraction is the sum of the amounts treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D), and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as deemed distributions taxable as dividends. The denominator of the fraction is the taxable income of the DISC for the taxable year, reduced by the amounts treated under section 995(b)(1) (A), (B), and (C) as deemed distributions taxable as dividends. However, in no event shall the numerator exceed the denominator. The remainder of such dividend will be treated as gross income from sources without the United States.

(iv) *Determination of source of income for dividends that reduce accumulated DISC income.* (*a*) If no portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the entire amount of any dividend that reduces under § 1.996-3(b)(3) accumulated DISC income will be treated as income from sources without the United States.

(*b*) If any portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the portion of any dividend during its taxable year that reduces under § 1.996-3(b)(3) accumulated DISC income that will be treated as income from sources within the United States shall be equal to the amount of such dividend multiplied by a fraction (determined as of the close of such year) the numerator of which is the amount of accumulated DISC income attributable to nonqualified export taxable income, and the denominator of which is the total amount of accumulated DISC income. The remainder of such dividend will be treated as gross income from sources without the United States.

(v) *Special rules.* For purposes of subdivisions (iii) and (iv) of this subparagraph—

(*a*) Taxable income shall be determined under § 1.992-3(b)(2)(i) (relating to the computation of deficiency distribution), and

(*b*) The portion of any deemed distrubution taxable as a dividend, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) or amount under § 1.996-3(b)(3) (i) through (iv) that is treated as gross income from sources within the United States during the taxable year shall be considered to reduce the amount of nonqualified export taxable income as of the close of such year.

(vi) *Illustrations.* This subparagraph may be illustrated by the following examples:

Example (*1*). (a) Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1973, Y has $18,000 of taxable income from qualified export receipts (none of which are interest and gains described in section 995(b)(1) (A), (B), and (C) and $1,000 of nonqualified export taxable income. Under these facts, X is deemed to have received a distribution under section 995(b)(1)(D) of $9,500, i.e., $19,000 × ½. X is treated under subdivision (iii)(*b*) of this subparagraph as having $500, i.e., $1,000 × $9,500/$19,000, from sources within the United States and $9,000 from sources without the United States.

(b) For 1972, assume that Y did not have any nonqualified export taxable income. Pursuant to subdivision (v)(*b*) of this subparagraph, at the beginning of 1974, $500 of Y's accumulated DISC income is attributable to nonqualified export taxable income (iii)(*a*) of this subparagraph), i.e., $1,000—$500.

Example (*2*). The facts are the same as in example (1) except that in 1973, in addition to the taxable income described in such example, Y has $450 of taxable income from gross interest from producer's loans described in section 995(b)(1)(A). Under these facts, the deemed distribution of $450 under section 995(b)(1)(A) is treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States. The deemed distribution under section 995(b)(1)(D) of $9,500 will be treated in the same manner as in example (1) *i.e.*, $1,000 · $9,500/($19,450-450).

Example (*3*). (a) The facts are the same as in example (1) except that in 1973, in addition to the distributions described in such example, Y makes a deemed distribution taxable as a dividend of $100 under section 995(b)(1)(E) (relating to foreign investment attributable to producer's loans) and actual distributions of all of its previously taxed income and of $2,000 taxable as a dividend which reduces accumulated DISC income (as defined in subdivision (ii)(*b*) of this subparagraph). Under § 1.996-3(b)(3), accumulated DISC income is first reduced by the deemed distribution of $100 and then by the actual distribution taxable as a dividend of $2,000. As indicated in example (1), for 1972 Y did not have any nonqualified export taxable income. Assume that Y had accumulated DISC income of $12,000 at the end of 1973, $500 of which under example (1) is attributable to nonqualified export taxable income.

(b) The distribution from previously taxed income is excluded from gross income pursuant to section 996(a)(3).

(c) Of the deemed distribution of $100, X is treated under subdivision (iv)(*b*) as having $4.17, i.e., $100 × 500/12,000, from sources within the United States and $95.83, i.e., $100—$4.17, from sources without the United States.

(d) Of the actual distribution taxable as a dividend of $2,000, X is treated under subdivision (iv)(*b*) as having $83.33, i.e., $2,000 × 500/12,000, from sources within the United States and $1,916.67, i.e., $2,000—$83.33, from sources without the United States.

(e) The sum of the amounts deemed and actually distributed as dividends for 1973 that are treated as gross income from sources within the United States is as follows:

	Total dividend	Amount of dividend from sources within the United States
Deemed distribution under sec. 995(b)(1)(D)	$9,500	$500.00
Deemed distribution under sec. 995(b)(1)(E)	100	4.17
Actual distribution that reduces accumulated DISC income	2,000	83.33
Totals	11,600	587.50

Thus, pursuant to subdivision (v)(*b*) of this subparagraph, at the beginning of 1974 Y has $412.50, i.e., $1,000—$587.50, of nonqualified export taxable income.

(f) The result would be the same if Y made an actual distribution taxable as a dividend of $1,500 on March 30, 1973, and another distribution of $500 on December 31, 1973.

Example. (*4*). (a) Z is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. W is its sole shareholder. At the end of the 1976 Z has previously taxed income of $12,000 and accumulated DISC income of $4,000, $900 of which is attributable to nonqualified export taxable income. In 1977, Z has $20,050 of taxable income from qualified export receipts, of which $550 is from gross income from producer's loans described in section 995(b)(1)(A); Z has $950 of taxable income giving rise to gross receipts which are not qualified export receipts, of which $450 is gain described in section 995(b)(1)(B). Of its total taxable income of $21,000 (which is equal to its earnings and profits for 1977), $1,000 is attributable to sales of military property. Z has an international boycott factor (determined under section 999) of .10, and made an illegal bribe (within the meaning of section 162(c)) of $1,265. The proportion which the amount of Z's adjusted base period export receipts bears to Z's export gross receipts for 1977 is .40 (see section 995(e)(1)). Z makes a deemed distribution taxable as a dividend of $1,000 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of $32,000.

(b) The deemed distributions of $550 under section 995(b)(1)(A) and $450 under section 995(b)(1)(B) are treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States.

(c) Under these facts, Z has also made the following deemed distributions taxable as dividends to W under the following subdivisions of section 995(b)(1):

(D)	$500,	*i.e.*, ½ × $1,000.
(E)	7,800,	*i.e.*, .40 × [$21.000–$(550 + 450 + 500)].
(F)(i)	5,850,	*i.e.*, ½ × [$21,000–$550 + 450 + 500 + 7,800)].
(ii)	585,	*i.e.*, $5,850 × .10
(iii)	1,265	
Total.	16,000	

(d) The portion of the total amount of these deemed distributions ($16,000 that is treated under the subdivision (iii)(*b*) as gross income from sources within the United States is computed as follows:

(1) The amount of nonqualified export taxable income is $500, i.e., taxable income giving rise to gross receipts which are not qualified export receipts ($950) minus gain described in section 995(b)(1) (B) or (C) ($450).

(2) $500 × ($16,000/$[21,000–(550 + 450)]) = $400.

The remainder of these distributions, $15,600 ($16,000 minus $400), is treated under subdivision (iii)(*b*) of this subparagraph as gross income from sources without the United States.

(e) The earnings and profits accounts of Z at the end of 1977 are computed as follows:

	Total earnings and profits	Previously taxed income	Accumulated DISC income attributable to taxable income from translations which give rise to gross receipts which—	
			Are qualified export receipts	Are not qualified export receipts
(1) Balance: Jan. 1, 1977	$16,000	$12,000	$3,100	$900
(2) (Earnings and profits for 1977, before actual and sec. 955(b)(1)(G) distributions	21,000	17,000	3,900	[1] 100
(3) Balance: Dec. 31, 1977	37,000	29,000	7,000	1,000
(4) Distribution under sec. 995(b)(1)(G)		1,000	(875)	[2] (125)
(5) Balance	37,000	30,000	6,125	875
(6) Actual distribution	(32,000)	(30,000)	(1,750)	[3] (250)
(7) Balance: Jan. 1, 1978	5,000		4,375	625

[1] The total of nonqualified export taxable income ($500) minus the portion of such income, under subdivision (iii)(*b*) of this subparagraph, deemed distributed pursuant to section 995(b)(1)(D), (E), and (F) ($400), as computed under (d)(2) of this example.

[2] Under subdivision (iv)(*b*) of this subparagraph, $1,000/$8,000 × $1,000.

[3] Under subdivision (iv)(*b*) of this subparagraph, $1,000/$8,000 × $2,000 (amount of actual distribution that reduces accumulated DISC income).

(b) *Special rules*—(1) *Foreign corporation having no gross income for period preceding declaration of dividend.* If the foreign corporation has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (a)(3)(i) of this section, the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of such corporation in which the declaration of the dividend occurs. This subparagraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the foreign corporation, from the fact that such corporation is newly created or organized, or from any other cause.

(2) *Transitional rule.* For purposes of applying paragraph (a)(3)(i) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89-809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business within the United States by such foreign corporation.

(3) *Gross income determinations.* In making determinations under subparagraph (2) or (3) of paragraph (a) of this section, or subparagraph (2) of this paragraph—

(i) The gross income of a domestic corporation is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code.

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(c) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude any dividend from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the corporation paying the dividend, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the paying corporation setting forth such information and indicating the amount of the dividend to be treated as income from sources within the United States may be used for this purpose. See §§ 1.6012-1(b)(1)(i) and 1.6012-2 (g)(1)(i).

(d) *Effective date.* This section applies with respect to dividends received or accrued after December 31, 1966, except that paragraph (a)(5) of this section applies to certain dividends from a DISC or former DISC in taxable years ending after December 31, 1971. For purposes of paragraph (a)(5) of this section, any reference to a distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after December 31, 1975, shall also constitute a reference to any distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after November 30, 1975, but before January 1, 1976. For corresponding rules applicable with respect to dividends received or accrued before January 1, 1967, see 26 CFR 1.861-3 (Rev. as of Jan. 1, 1972).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6830, 30 FR 8046, June 23, 1965; T.D. 7378, 40 FR 45432, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 7472, 42 FR 12179, Mar. 3, 1977; T.D. 7591, 44 FR 5116, Jan. 25, 1979]

§ 1.861-4 Compensation for labor or personal services.

(a) *In general.* (1) Gross income from sources within the United States includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment; except that such compensation shall be deemed not to be income from sources within the United States, if—

(i) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during his taxable year,

(ii) The compensation for such labor or services does not exceed in the aggregate a gross amount of $3,000, and

(iii) The compensation is for labor or services performed as an employee of, or under any form of contract with—

(*a*) A nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(*b*) An individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.

(2) As a general rule, the term "day", as used in subparagraph (1)(i) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(3) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(4) In determining for purposes of subparagraph (1)(ii) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of $3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in § 1.162-17 and paragraph (e)(4) of § 1.274-5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to labor or personal services performed in the United States are not to be taken into account for purposes of subparagraph (1)(ii) of this paragraph. (5) For definition of the term "United States", when used in a geographical sense, see sections 638 and 7701(a)(9).

(b) *Amount includible in gross income*—(1) *Taxable years beginning after December 31, 1975.* (i) If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case. In many cases the facts and circumstances will be such that an apportionment on the time basis will be acceptable, that is, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. In other cases, the facts and circumstances will be such that another method of apportionment will be acceptable.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). B, a nonresident alien individual, was employed by M from March 1, 1976, to June 12, 1976, a total of 104 days, for which he received compensation in the amount of $12,240. During that period B was present in the United States 59 days. Under his contract B was subject to call at all times by his employer and was in a payment status on a 7-day week basis. There was no specific agreement as to the amount of pay for services performed within the United States; moreover, he received his stipulated salary payments regardless of the number of days per week he actually performed services. Under these circumstances the amount of compensation to be included in gross income as income from sources within the United States will be $6,943.85 ($12,240 × 59/104).

Example (*2*). C, a citizen of the United States, was a resident of a foreign country during his entire taxable year. He is employed by N, a domestic corporation, and paid a salary of $17,600 per annum. Under his contract C is required to work only on a 5-day week basis, Monday through Friday. During 1976 he was in the United States for 6 weeks, performing services therein for N for 30 work days. During the year he worked 240 days for N for which payment was made, determined by eliminating his vacation period for which no payment was made. Under these circumstances the amount of compensation for personal services performed in the United States is $2,200 ($17,600 × 30/240).

(2) *Taxable years beginning before January 1, 1976.* If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

(c) *Coastwise travel.* Except as to income excluded by paragraph (a) of this section, wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

(d) *Effective date.* This section applies with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.861-4 (Rev. as of Jan. 1, 1972).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7378, 40 FR 45433, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

§ 1.861-5 Rentals and royalties.

Gross income from sources within the United States includes rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, in the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States. For taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of § 1.871-11.

[T.D. 7378, 40 FR 45434, Oct. 2, 1975]

§ 1.861-6 Sale of real property.

Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

§ 1.861-7 Sale of personal property.

(a) *General.* Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession.* Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. See section 863(b)(3) and § 1.863-2.

(c) *Country in which sold.* For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale.* For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863(b)(2) and paragraphs (b) of §§ 1.863-1 and 1.863-2.

(e) *Section 306 stock.* For determining the source of gain on the disposition of section 306 stock, see section 306(f) and the regulations thereunder.

§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) *In general*—(1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 871(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the resid-

ual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income. If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income.

(3) *Class of gross income.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61, namely:

(i) Compensation for services, including fees, commissions, and similar items;

(ii) Gross income derived from business;

(iii) Gains derived from dealings in property;

(iv) Interest;

(v) Rents;

(vi) Royalties;

(vii) Dividends;

(viii) Alimony and separate maintenance payments;

(ix) Annuities;

(x) Income from life insurance and endowment contracts;

(xi) Pensions;

(xii) Income from discharge of indebtedness;

(xiii) Distributive share of partnership gross income;

(xiv) Income in respect of a decedent;

(xv) Income from an interest in an estate or trust.

(4) *Statutory grouping of gross income and residual grouping of gross income.* For purposes of this section, the term "statutory grouping of gross income" or "statutory grouping" means the gross income from a specific source or activity which must first be determined in order to arrive at "taxable income" from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the "residual grouping of gross income" or "residual grouping." For example, for purposes of determining taxable income from sources within specific foreign countries and possessions of the United States, in order to apply the per-country limitation to the foreign tax credit (as in effect before enactment of the Tax Reform Act of 1976), the statutory groupings are the separate gross incomes from sources within each country and possession. Moreover, if the taxpayer has income subject to section 904(d) (as in effect after enactment of the Tax Reform Act of 1976), such income constitutes one or more separate statutory groupings. In the case of the per-country limitation, the residual grouping is the aggregate of gross income from sources within the United States. In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. See paragraph (d)(2) of this section with respect to the allocation and apportionment of deductions to excluded income.

(5) *Effective date.* The provisions of this section shall be applicable to taxable years beginning after December 31, 1976. For taxable years beginning before January 1, 1977, § 1.861-8 as in effect on October 23, 1957 (T.D. 6258), as amended on August 22, 1966 (T.D. 6892) and on September 29, 1975 (T.D. 7378), will apply.

(b) *Allocation*—(1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxpayable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) *Relationship to activity or property.* A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example (17) of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated, or could reasonably have been expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) other than to expenses attributable to stewardship activities, see examples (19) through (21) of paragraph (g) of this section. See paragraph (e)(4) of this section for the allocation and apportionment of deductions attributable to stewardship activities.

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) *Deductions related to all gross income.* If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the

contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. If the class of gross income to which a deduction has been allocated is included in its entirety in either a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(2) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in the statutory grouping or in each of the statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which there is an excess of deductions. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to—

(i) Comparison of units sold attributable to the statutory grouping and attributable to the residual grouping;

(ii) Comparison of the amount of gross sales or receipts;

(iii) Comparison of costs of goods sold;

(iv) Comparison of profit contribution;

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income; and

(vi) Comparison of the amount of gross income in the statutory grouping with the amount in the residual grouping.

Paragraphs (e)(2) through (e)(8) of this section provide the applicable rules for allocation and apportionment of deductions for interest, research, and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) of this section may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not definitely related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(2) of this section.

(2) *Deductions not definitely related to any gross income.* If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the re-

sidual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income.

(d) *Excess of deductions and excluded and eliminated income*—(1) *Excess of deductions.* Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See § 1.1502-4(d)(1) and the last sentence of § 1.1502-12. For an illustration of the principles of this paragraph (d)(1), see example (17) of paragraph (g) of this section.

(2) *Allocation and apportionment to exempt, excluded or eliminated income.* In allocating or apportioning deductions to classes or statutory groupings of gross income, including apportionment pursuant to paragraph (c)(2) of this section (deductions not definitely related to any class of gross income), gross income shall include amounts which are otherwise exempt or excluded (such as the income of a nonresident alien individual or foreign corporation which is not effectively connected income) or which are otherwise eliminated in the computation of consolidated taxable income reported for the taxable year on a consolidated return (but deferred intercompany transactions, as defined in § 1.1502-13, shall not be included until the year they are included in taxable income). Hence, a deduction may be allocated and apportioned to exempt, excluded, or eliminated income. See example (24) of paragraph (g) of this section. No deduction shall be allowed, under this section, for any amount, or part thereof, allocable and apportionable to a class of exempt, excluded, or eliminated income, if such amount is not allowed as a deduction under another section of the Code. See section 265 and the regulations thereunder.

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Subparagraphs (4) through (8) of this paragraph contain rules with respect to the allocation of certain other deductions. Subparagraph (9) of this paragraph lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Subparagraph (10) of this paragraph lists special deductions of corporations which must be allocated and apportioned. Subparagraph (11) of this paragraph lists personal exemptions which are neither allocated nor apportioned. Examples of allocation and apportionment are contained in paragraph (g) of this section.

(2) *Interest*—(i) *In general.* The method of allocation and apportionment for interest set forth in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring

an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see § 1.882-5.

(ii) *Allocation of interest.* Except as provided in subdivisions (iii) and (iv) of this subparagraph, the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

(iii) *Certain nonbusiness interest.* Interest expense deductible under section 163 which is not paid or incurred during the taxable year

(A) In carrying on any trade or business,

(B) For the production or collection of income,

(C) For the management, conservation, or maintenance of property held for the production of income, or

(D) In connection with the determination, collection, or refund of any tax shall be considered a deduction which is not definitely related to any class of gross income. For example, interest paid or incurred by an individual on a mortgage which constitutes part or all of the purchase price of his personal residence shall normally be considered a deduction which is not definitely related to any class of gross income.

(iv) *Allocation of interest to specific property.* (A) If the existence of all of the facts and circumstances described below is established, the deduction for interest shall be considered definitely related solely to the class of gross income which the specific property generates, has generated, or could reasonably have been expected to generate. Such facts and circumstances are as follows:

(*1*) The indebtedness on which the interest was paid was specifically incurred for the purpose of purchasing, maintaining, or improving the specific property;

(*2*) The proceeds of the borrowing were actually applied to the specified purpose;

(*3*) The creditor can look only to the specific property (or any lease or other interest therein) as security for payment of the principal and interest of the loan and, thus, cannot look to any other property or the borrower with respect to payment of the loan;

(*4*) It may be reasonably assumed that the return (cash flow) on or from the property will be sufficient to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payment of principal and interest; and

(*5*) There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in (*3*) and (*4*) of this subdivision (iv)(A).

Even though the above facts and circumstances are present in substance as well as in form, a deduction for interest will not be considered definitely related to specific property where the motive for structuring the transaction in the manner described above was without any economic significance.

(B) Where an interest deduction is definitely related solely to specific property under (A) of this subdivision (iv), such interest deduction and such property or the portion thereof, to which such interest deduction relates shall not be included in the allocation described in subdivision (ii) of this paragraph (e)(2). Instead, the interest deduction shall be allocated solely to the gross income derived from the specific property and apportioned accordingly. Thus, if an apportionment is made on the basis of book values and it is determined that the deduction for certain interest is definitely related to $800,000 of book value of certain property which has a total book value of $1 million, only the $200,000 balance will be included for purposes of allocating and apportioning the remaining portion of the interest deduction which is related to all other activities and properties.

(v) *Apportionment of interest—asset method.* Normally, the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets which may produce substantially different yields of gross income in relation to their value. Thus, apportionment of an interest deduction on such basis as gross income may not be reasonable. If a taxpayer consistently apportions the deduction for interest on the basis of the tax book value (original cost for tax purposes less depreciation allowed for tax purposes) of its assets, that method will ordinarily be accepted. Alternatively, if a taxpayer can apportion the deduction on the basis of the fair market value of his assets and he can establish the fair market value to the satisfaction of the Commissioner, that method will also be acceptable. However, once the taxpayer uses fair market value the taxpayer must continue to use such method unless expressly authorized by the Commissioner to change his method. For purposes of determining values of assets under this subdivision (v) an average of values (book or market) shall be computed for the year on the basis of values of assets at the beginning and end of the year. Where a substantial distortion of asset values would result from the use of such an averaging basis, an appropriate method satisfactory to the Commissioner shall be used.

(vi) *Apportionment of interest—optional gross income methods.* If the conditions of either (A) or (B) of this subdivision (vi) are met, in lieu of apportioning the deduction for interest expense (allocable under subdivision (ii) of this paragraph (e)(2) under subdivision (v) of this paragraph (e)(2), a taxpayer may for any taxable year apportion such deduction, as prescribed in this (A) or (B), between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income. However, if any member of an affiliated group which files a consolidated return apportions its interest expense for a taxable year under this subdivision (vi), then all members joining that return must use this subdivision (vi) for such taxable year.

(A) *Option one.* If, when apportioned ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount of gross income,

(*1*) The amount of interest expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (v) of this paragraph (e)(2), and

(*2*) The amount of interest expense ratably apportioned to the residual grouping is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (v) of this paragraph (e)(2), then the taxpayer may apportion his interest expense ratably on the basis of gross income.

(B) *Option Two.* If, when the amount of interest expense is apportioned ratably on the basis of gross income, either condition (*1*) or (*2*) of (A) of this subdivision (vi) is not met, the taxpayer may either:

(*1*) *Where condition* (*1*) of (A) of this subdivision (vi) is not met, apportion fifty percent (50%) of the amount of interest expense which would have been apportioned to the statutory grouping (or groupings in the aggregate) under subdivision (v) of this paragraph (e)(2), to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping), and apportion the balance of the amount of interest expense to the residual grouping; or

(*2*) Where condition (*2*) of (A) of this subdivision (vi) is not met, apportion fifty percent (50%) of the amount of the interest expense which would have been apportioned to the residual grouping, under subdivision (v) of this paragraph (e)(2) to such residual grouping, and apportion the balance to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(vii) *Apportionment of interest—obligations incurred before January 1, 1977.* At the option of the taxpayer, the rules of § 1.861-8 as in effect on October 23, 1957 (T.D. 6892) and on September 29, 1975 (T.D. 7378) may be applied with respect to interest paid on obligations incurred before January 1, 1977. For taxpayers using this option, the interest on obligations to which this option does not apply will be allocated and apportioned under the rules of this paragraph (e)(2), other than subdivision (vi). For purposes of this subdivision (vii), obligations payable on demand shall be deemed to have been incurred on or after January 1, 1977. A taxpayer who, for any taxable year, apportions his interest deduction using either of the optional gross income methods of subdivision (vi) of this paragraph (e)(2) shall not for such taxable year or for any taxable year thereafter have the option provided in this subdivision (vii).

(viii) *Examples.* Examples (1) and (2) of paragraph (g) of this section illustrate the allocation and apportionment of interest deductions.

(3) *Research and experimental expenditures*—(i) *Allocation*—(A) *In general.* The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development. Expenditures for research and development which a taxpayer deducts under section 174 shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) which a taxpayer may be considered to have shall be limited to the following list. Ordinarily a taxpayer's research and development expenditures may be divided between the relevant product categories. Where research and development is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories in this list. Where research and development is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and budget, Standard Industrial Classification Manual, 1972 (or later edition, as available).

SIC Major Groups	Nonmanufactured categories
(01, 02, 07, 08, 09)	Agriculture, forestry and fisheries.
(10, 11, 12)	Hard mineral mining.
(13)	Crude petroleum, and natural gas.
(14)	Nonmetallic minerals.
(15, 16, 17)	Construction services.
(40, 41, 42, 43, 44, 45, 46, 47).	Transportation services.
(48)	Communication.
(49)	Electric, gas and sanitary services.
(50, 51)	Wholesale trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories).

SIC Major Groups	Nonmanufactured categories
(52. 53, 54, 55, 56, 57, 58, 59).	Retail trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories, except Wholesale trade, and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except Wholesale trade).
(60, 61, 62, 63, 64, 65, 66, 67).	Finance, insurance, and real estate.
(70, 72, 73, 75, 76, 78, 79, 80, 81, 82, 83, 84, 86, 88, 89).	Other services.
(20)	Food and kindred products.
(21)	Tobacco manufacturers.
(22)	Textile mill products.
(23)	Apparel and other finished products made from fabrics and similar materials.
(24)	Lumber and wood products, except furniture.
(25)	Furniture and fixtures.
(26)	Paper and allied products.
(27)	Printing, publishing, and allied industries.
(28)	Chemicals and allied products.
(29)	Petroleum refining and related industries.
(30)	Rubber and miscellaneous plastics products.
(31)	Leather and leather products.
(32)	Stone, clay, glass and concrete products.
(33)	Primary metal industries.
(34)	Fabricated metal products, except machinery and transportation equipment.
(35)	Machinery, except electrical.
(36)	Electrical and electronic machinery, equipment and supplies.
(37)	Transportation equipment.
(38)	Measuring, analyzing, and controlling instruments; photographic, medical and optical goods; watches and clocks.
(39)	Miscellaneous manufacturing industries.

(B) *Exception.* Where research and development is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generage amounts of gross income (beyond de minimis amounts) outside a single geographic source, the deduction for such research and development shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in subdivisions (ii)(B) and (iii) of this paragraph (e)(3)). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(ii) *Apportionment of research and development—sales method*—(A) *Exclusive apportionment.* Where an apportionment based upon geographic sources of income of a deduction for research and development is necessary (after applying the exception in subdivision (i)(B) of this paragraph (d)(3), an amount equal to—

(*1*) Fifty percent (50%), in the case of a taxable years beginning during 1977,

(*2*) Forty percent (40%), in the case of a taxable year beginning during 1978,

(*3*) Thirty percent (30%), in the case of a taxable year beginning during 1979, and thereafter,

of such deduction for research and development shall be apportioned exclusively to the statutory grouping of gross income or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and development activities which account for more than fifty percent (50%) of the amount of such deduction were performed. If the fifty percent test of the preceding sentence is not met, then no part of the deduction shall be apportioned under this subdivision (ii)(A). This exclusive apportionment reflects the view that research and development is often most valuable in the country where it is performed, for two reasons. First, research and development often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of which may be sold in foreign markets. Second, research and development often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater percent than the relevant percent specified in (*1*), (*2*) or (*3*) of this subdivision (ii)(A) because the research and development is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under (C) of this subdivision (ii)) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under (D) of this subdivision (ii)) which can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for nonmanufactured categores, solely to those enumerated in Executive Office of the President, Office of Management and Budget *Standard Industrial Classification Manual*, 1972 (or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level on pages 5 through 200 of U.S. Bureau of the Census, *Census of Manufactures: 1972, Numerical List of Manufactured Products* (*New* (*1972*) *SIC Basis*), 1973, (or later edition, as available). Examples (9), (10), and (13) in paragraph (g) of this section illustrate the application of this rule. For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and processes (not limited by those listed in the *Standard Industrial Classification Manual* or the *Numerical List of Manufactured Products*) in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under (C) of this subdivision (ii)) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under (D) of this subdivision (ii)) which can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish, by reference to the cost of money and the number of years during which economic benefit can be directly attributable to the results of the taxpayer's research, that another discount rate is more appropriate (see examples (9) through (12) in paragraph (g) of this section).

(B) *Remaining apportionment.* The amount equal to the remaining portion of such deduction for research and development, not apportioned under (A) of this subdivision (ii), shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) which resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories). For the purposes of this paragraph (e)(3), amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year. Amounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See paragraph (d)(1) of this section for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(C) *Sales of uncontrolled parties.* For purposes of the apportionment under (B) of this subdivision (ii), the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property which was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate should be made. In the case of sales of intangible property, and in cases where a reasonable estimate of sales of licensed products cannot be made, the sales taken into account shall be an amount which is ten times the amount received or accrued for the intangible during the taxpayer's taxable year. For purposes of this subdivision (ii)(C), the term "uncontrolled party" means a party which is not a person with a relationship to the taxpayer (specified in section 267(b)), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993 (a)(3). An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party, or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs.

(D) *Sales of controlled parties.* For purposes of the apportionment under (B) of this subdivision (ii), the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (of categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in (*1*) or (*2*) of this subdivision (ii)(D) for determining the taxpayer's apportionment, if such corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category or categories). However, sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corporation shall be subtracted from the sales of the buying corporation. For purposes of this subdivision (ii)(D), the term "a corporation controlled by the taxpayer" means any corporation other than an "uncontrolled party" as defined in (C) of this subdivision (ii). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be exptected to license, sell, or transfer intangible property to that corporation, or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and development shall be considered in determining reasonable expectations. However, if the corporation controlled by the taxpayer has entered into a bonafide cost-sharing arrangement, in accordance with the provisions of § 1.482-2(d)(4), with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense. The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be the greater of—

(*1*) The amount of sales that would have been taken into account under paragraph (e)(3)(ii)(C) of this section if the controlled corporation were an uncontrolled party and if any intangible property contributed by the taxpayer to the controlled corporation were treated as a license of that intangible property; or

(*2*) The amount of sales that bear the same proportion to total sales of the controlled corporation as the taxpayer's direct or indirect ownership, as defined in section 1563, of the total combined voting power of all classes of stock entitled to vote of such corporation bears to the total outstanding combined voting power of all such classes of stock of such corporation.

(iii) *Apportionment of research and development—optional gross income methods.* If the conditions of either (A) or (B) of this subdivision (iii) are met, in lieu of apportioning the deduction for research and development expense under subdivision (ii) of this paragraph (e)(3), a taxpayer may, at his option, for any taxable year apportion such deduction, as prescribed in (A) or (B) of this subdivision (iii), between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income. These optional methods must be applied to the taxpayer's entire deduction for research and development expense remaining after applying the exception in subdivision (i)(B) of this paragraph (e)(3), and may not be applied on a product category basis. However, if any member of an affiliated group which files a consolidated return apportions its research and development expense for a taxable year under this subdivision (iii), then all members joining that return must use this subdivision (iii) for such taxable year.

(A) *Option One.* If, when apportioned ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount of gross income,

(*1*) The amount of research and development expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (ii) of this paragraph (e)(3), and

(*2*) The amount of research and development expense ratably apportioned to the residual grouping is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (ii) of this paragraph (e)(3),

then the taxpayer may apportion his research and development expense ratably on the basis of gross income.

(B) *Option Two.* If, when the amount of research and development expense is apportioned ratably on the basis of gross income, either condition (*1*) or (*2*) of (A) of this subdivision (iii) is not met, the taxpayer may either:

(*1*) Where condition (*1*) of (A) of this subdivision (iii) is not met, apportion fifty percent (50%) of the amount of research and development expense which would have been apportioned to the statutory grouping (or groupings in the aggregate) under subdivision (ii) of this paragraph (e)(3) to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and development expenses to the residual grouping; or

(*2*) Where condition (*2*) of (A) of this subdivision (iii) is not met, apportion fifty percent (50%) of the amount of research and development expense which would have been apportioned to the residual grouping under subdivision (ii) of this paragraph (e)(3) to such residual grouping, and apportion the balance of the amount of research and development expenses to the statutory grouping (or to the statutory groupings in the aggregate and then amoung such groupings ratably on the basis of gross income within each grouping).

(iv) *Examples.* Examples (3) through (16) and example (23) of paragraph (g) of this section illustrate the allocation and apportionment of research and development deductions.

(4) *Stewardship expenses attributable to dividends received.* If a corporation renders services for the benefit of a related corporation and the corporation charges the related corporation for such services (see section 482 and the regulations thereunder which provide for an allocation where the charge is not on an arm's length basis as determined therein), the deductions for expenses of the corporation attributable to the rendering of such services are considered definitely related to the amounts so charged and are to be allocated to such amounts. However, the regulations under section 482 (§ 1.482-2(b)(2)(ii) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute "stewardship" or "overseeing" functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself. For example, assume that a related corporation, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs and submits a report of its findings and a plan of borrowing to the parent corporation, and the parent corporation's financial staff reviews the findings and plans to determine whether to advise the related corporation to reconsider its plan. The services of review performed by the parent corporation for its own benefit are of a stewardship or overseeing character. The deductions resulting from stewardship or overseeing functions are incurred as a result of, or incident to, the ownership of the related corporation and, thus, shall be considered definitely related and allocable to dividends received or to be received from the related corporation. If a corporation has a foreign or international department which exercises stewardship or overseeing functions with respect to related foreign corporations and, in addition, the department has other functions which are attributable to other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign royalties, and gross income of foreign branches) to which its deductions are also to be allocated, some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also be attributable to United States source income (such as fees for services performed in the United States) to which its deductions are to be allocated. Methods of apportionment which could possibly be utilized with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See examples (17) and (18) of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship activities.

(5) *Legal and accounting fees and expenses.* Fees and other expenses for legal and accounting services are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered (and are apportioned as provided in paragraph (c)(1) of this section). For example, accounting fees for the preparation of a study of the costs involved in manufacturing a specific product will ordinarily be definitely related to the class of gross income derived from (or which could reasonably have been expected to be derived from) that specific product. The tax-

payer is not relieved from his responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as "professional," or does not provide any type of allocation, or does not properly allocate the fees involved.

(6) *Income taxes.* The deduction for State, local, and foreign income, war profits and excess profits taxes allowed by section 164 shall be considered definitely related and allocable to the gross income with respect to which such taxes are imposed. For example, if a domestic corporation is subject to State income tax and the amount of such State income tax is imposed in part on the amount of foreign source income, that part of such State income tax attributable to foreign source income is definitely related and allocable to foreign source gross income. Examples (25) and (26) of paragraph (g) of this section illustrate the application of this subparagraph (6).

(7) *Losses on the sale, exchange, or other disposition of property*—(i) *Allocation.* The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise in the hands of the taxpayer. Where the nature of gross income generated from the asset or property has varied significantly over several taxable years of the taxpayer, such class of gross income shall generally be determined by reference to gross income generated from the asset or property during the taxable year or years immediately preceding the sale, exchange, or other dispostion of such asset or property. Thus, for example, where an asset generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) *Apportionment of losses.* Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(8) *Net operating loss deduction.* A net operating loss deduction allowed under section 172 shall be treated as a deduction definitely related and allocable to the class of gross income to which the activity or property which generated the net operating loss gave rise or could reasonably have been expected to give rise. The net operating loss deduction shall be apportioned between the statutory grouping of gross income (or groupings) and the residual grouping of gross income within the class of gross income on the basis of amounts of the net operating loss attributable to the respective groupings of income in the year when the net operating loss arose.

(9) *Deductions which are not definitely related.* Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(2) of this section, are—

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213;

(iv) The deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B); and

(v) The deduction for alimony payments allowed by section 215.

(10) *Special deductions.* The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be allocated and apportioned consistent with the principles of this section.

(11) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

(f) *Miscellaneous matters*—(1) *Operative sections.* The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) *Overall limitation to the foreign tax credit.* Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment) the amount of the foreign tax credit may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Accordingly, in this case, the statutory grouping is foreign source income (including, for example, interest received from a domestic corporation which meets the tests of section 861(a)(1)(B), dividends received from a domestic corporation which has an election in effect under section 936, and other types of income specified in section 862). Pursuant to sections 862(b) and 863(a) and §§ 1.862-1 and 1.863-1, this section provides rules for identifying the deductions to be taken into account in determining taxable income from sources without the United States. See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example (3) of paragraph (g) of this section for one example of the application of this section to the overall limitation.

(ii) *Per-country limitation to the foreign tax credit.* Under the per-country limitation to the foreign tax credit, as provided in section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976), the amount of the foreign tax credit for income taxes paid to a specific foreign country (or possession of the United States) may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources within the foreign country and the denominator of which is the entire taxable income. Pursuant to § 1.863-6, the gross income and the taxable income from sources within a specific foreign country are determined under the same principles as are applied in determining gross income from sources within the United States (generally §§ 1.861-1 to 1.861-7) and taxable income from sources within the United States (generally this section). See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example (16) of paragraph (g) of this section for an example of the application of this section to the per-country limitation.

(iii) *DISC taxable income.* Section 994 provides rules for determining the taxable income of a DISC with respect to qualified sales and leases of export property and qualified services. The "50-50" combined taxable income method available for making such determination provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from such sales and leases of export property and such services. Pursuant to regulations under section 994, this section provides rules for determining the deductions to be taken into account in determining such combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under section 994(b)(2) if used by the taxpayer as provided therein. See examples (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of both the general and special "no loss" rules of the regulations under section 994.

(iv) *Effectively connected taxable income.* Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see § 1.882-5)) which are to be taken into account in determining taxable income. See example (21) of paragraph (g) of this section.

(v) *Foreign base company income.* Section 954 defines the term "foreign base company income" with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation "properly allocable to such income". This section provides rules for identifying which deductions are properly allocable to foreign base company income.

(vi) *Other operative sections.* The rules provided in this section also apply in determining—

(A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;

(B) The amount of foreign mineral income under section 901(e);

(C) The amount of interest income and the income from certain distributions from a DISC or former DISC to which the foreign tax credit limitation is applied separately under section 904(d) (as in effect after enactment of the Tax Reform Act of 1976);

(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;

(E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for residents of Puerto Rico under section 933;

(G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;

(H) The income derived from Guam by an individual who is subject to section 935;

(I) The special deduction granted to China Trade Act corporations under section 941;

(J) The amount of certain U.S. source income excluded from the subpart F income of a controlled foreign corporation under section 952(b);

(K) The amount of income from the insurance of U.S. risks under section 953(b)(5);

(L) The international boycott factor and the specifically attributable taxes and income under section 999; and

(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, pt. 3). See 26 CFR 3.2(b)(3).

(2) *Application to more than one operative section.* Where more than one

operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(3) *Special rules of section 863(b)*—(i) *In general.* Special rules under section 863(b) provide for the application of rules of general apportionment provided in §§ 1.863-3 to 1.863-5, to worldwide taxable income in order to attribute part of such worldwide taxable income to U.S. sources and the remainder of such worldwide taxable income to foreign sources. The activities specified in section 863(b) are—

(A) Transportation or other services rendered partly within and partly without the United States,

(B) Sales of personal property produced by the taxpayer within and sold without the United States, or produced by the taxpayer without and sold within the United States, and

(C) Sales within the United States of personal property purchased within a possession of the United States.

In the instances provided in §§ 1.863-3 and 1.863-4 with respect to the activities described in (A), (B), and (C) of this subdivision, this section is applicable only in determining worldwide taxable income attributable to these activities.

(ii) *Relationship of sections 861, 862, 863(a), and 863(b).* Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources. Each of these four provisions applies independently. Where a deduction has been allocated and apportioned to income under one of these four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under section 863(b) take precedence over the general rules of Code sections 861, 862 and 863(a). For example, where a deduction is allocable in whole or in part to gross income to which section 863(b) applies, such deduction or part thereof shall not otherwise be allocated under section 861, 862, or 863(a). However, where the gross income to which the deduction is allocable includes both gross income to which section 863(b) applies and gross income to which section 861, 862, or 863(a) applies, more than one section must be applied at the same time in order to determine the proper allocation and apportionment of the deduction.

(4) *Adjustments made under other provisions of the Code*—(i) *In general.* If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the District Director shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(5) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the District Director to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent continues to incur expenses in connection with the supervision of the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the District Director to make an allocation under sec-

tion 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(ii) *Example.* X, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. X reported $1,500,000 as sales during the taxable year of which $1,000,000 was domestic sales and $500,000 was foreign sales. X took a deduction for expenses incurred by its marketing department during the taxable year in the amount of $150,000. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. Thus, X allocated and apportioned the marketing department deduction as follows:

To gross income from domestic sales: $150,000 × ($1,000,000/$1,500,000)	$100,000
To gross income from foreign sales: $150,000 × ($500,000/$1,500,000)	50,000
Total	150,000

On audit of X's return for the taxable year, the District Director adjusted, under section 482, X's sales to related foreign subsidiaries by increasing the sales price by a total of $100,000, thereby increasing X's foreign sales and total sales by the same amount. As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

To gross income from domestic sales: $150,000 × ($1,000,000/$1,600,000)	$93,750
To gross income from foreign sales: $150,000 × ($600,000/$1,600,000)	56,250
Total	150,000

(5) *Verification of allocations and apportionments.* Since, under this section, allocations and apportionments are made on the basis of the factual relationship between deductions and gross income, the taxpayer is required to furnish, at the request of the District Director, information from which such factual relationships can be determined. In reviewing the overall limitation to the foreign tax credit of a domestic corporation, for example, the District Director should consider information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. Thus, for example when requested by the District Director, the taxpayer shall make available any of its organization charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of organizational units, employees, and assets of the taxpayer and arrange for the interview of such of its employees as the District Director deems desirable in order to determine the gross income to which deductions relate. See section 7602 and the regulations thereunder which generally provide for the examination of books and witnesses. See also section 905(b) and the regulations thereunder which require proof of foreign tax credits to the satisfaction of the Secretary or his delegate.

(g) *General examples.* The following examples illustrate the principles of this section. In each example, unless otherwise specified, the operative section which is applied and gives rise to the statutory grouping of gross income is the overall limitation to the foreign tax credit under section 904(a). In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayer on a consistent basis from year to year (except in the case of the optional method for apportioning interest under paragraph (e)(2)(vi) of this section or the optional method for apportioning research and development expense under paragraph (e)(3)(iii) of this section). Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

Example (1)—Interest—(i) *Facts.* X, a domestic corporation, conducts a trade or business in the United States and owns all the stock of Y, a foreign corporation. In 1977, X takes a deduction for interest expenses of $150,000. No portion of this interest expense relates to an obligation issued before January 1, 1977. In 1977, X has gross receipts of $968,000, cost of goods sold of $600,000, and gross income of $368,000. X also receives a total of $32,000 in gross income from Y, consisting of $20,000 in dividends, $8,000 in royalties, and $4,000 in interest payments.

(ii) *Allocation.* No portion of the $150,000 deduction is definitely related solely to specific property within the meaning of paragraph (e)(2)(iv) of this section. Thus, X's deduction for interest is related to all of its activities and properties.

(iii) *Apportionment.* Since X computes its foreign tax credit limitation under the overall method there is one statutory grouping, gross income from sources outside the United States, and one residual grouping, gross income from sources within the United States. The interest deduction of $150,000 must be apportioned between these two groupings. In accordance with paragraph (e)(2) (v) and (vi) (but not (vii)) of this section, X calculates the apportionment of the interest deduction under both the asset and gross income methods. X determines the amount of capital utilized or invested in its income producing activities and properties by computing an average book value for the year for all of its assets on the basis of book values of assets as of the beginning and end of its year. In this example, it is assumed that a substantial distortion does not result from the use of beginning and end of year balances.

TENTATIVE APPORTIONMENT ON THE BASIS OF ASSETS

[Average beginning-end of year]

Assets (net of depreciation) which relate to activities and properties that generate U.S.-source income (including inventory, working capital for U.S. business, trade accounts receivable, factory equipment)	$3,200,000
Assets (net of depreciation) which relate to activities and properties that generate foreign-source income (including X's investment in Y and loan to Y, trade accounts receivable, a portion of X's home office based on space and equipment utilized for subsidiary supervision and working capital required for such supervision)	800,000
Total	4,000,000
As a result of the above computations, X would apportion its interest deduction as follows:	
To gross income from sources within the United States (residual grouping): $150,000 × ($200,000/$4,000,000)	120,000
To gross income from sources outside the United States (statutory grouping): $150,000 × (800,000/$4,000,000)	30,000
Total	150,000

TENTATIVE APPORTIONMENT ON THE BASIS OF GROSS INCOME

Interest expense apportioned to the residual grouping, gross income from sources within the U.S.: $150,000 × ($368,000/$400,000)	$138,000
Interest expense apportioned to the statutory grouping, gross income from sources outside the U.S.: $150,000 × ($20,000 + $8,000 + $4,000)/ ($400,000)	12,000
Total	150,000

Since the tentative apportionment ($12,000) to the statutory grouping on the basis of gross income is only 40 percent of the tentative apportionment ($30,000) on the basis of assets, X may use Option Two of the gross income method (paragraph (e)(2)(vi)(B) of this section) and apportion to the statutory grouping fifty percent (50%) of the $30,000 apportioned to that grouping under the asset method. Thus X's actual apportionment to the statutory grouping would be $15,000.

Example (2)—Interest—(i) *Facts.* X, a domestic corporation, has two wholly owned subsidiaries, Y and Z, which operate in foreign countries. In 1977, X, incurs an interest expense of $200,000 (not in any part attributable to an obligation issued before January 1, 1977) and has gross income of $500,000 consisting of: $392,000 from its domestic activities; $30,000 of dividends from foreign corporation Y; and $78,000 of dividends from foreign corporation Z. X's balance sheets show an average of beginning and ending asset values as follows: $3,200,000 in book value of assets related to its domestic source income; $800,000 in book value of assets related to its income from Y; and $1,000,000 in book value of assets related to its income from Z. X uses the overall method for calculating the limit on its foreign tax credit.

(ii) *Allocation.* No portion of X's $200,000 deduction for interest expense is definitely related solely to specific property within the meaning of paragraph (e)(2)(iv) of this section. Thus, X's deduction for interest is related to all of its income producing activities and properties.

(iii) *Apportionment.* For purposes of applying the overall limitation, there is one statutory grouping, gross income from sources outside the United States, and the residual grouping, gross income from sources within the United States. X's interest expense must be apportioned between these two groupings. Corporation X calculates tentative apportionments under the asset and gross income methods, in accordance with paragraphs (e)(2) (v) and (vi) (but not (vii)) of this section, as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF ASSETS

Interest expense apportioned to sources outside the United States (statutory grouping):	
$200,000 × [($800,000 + $1,000,000)/($800,000 + $1,000,000 + $3,200,000)]	$72,000
Interest expense apportioned to sources within the United States (residual grouping):	
$200,000 × [$3,200,000/($800,000 + $1,000,000 + $3,200,000)]	128,000
Total apportioned interest expense	200,000
Of which—	
Apportioned to statutory grouping	72,000
Apportioned to residual grouping	128,000

TENTATIVE APPORTIONMENT ON THE BASIS OF GROSS INCOME

Interest expense apportioned to sources outside the United States (statutory grouping):	
$200,000 × [($30,000 + $78,000)/($30,000 + $78,000 + $392,000)]	$43,200
Interest expense apportioned to sources within the United States (residual grouping):	
$200,000 × [$392,000/($30,000 + $78,000 + $392,000)]	156,800
Total apportioned interest expense	200,000
Of which—	
Apportioned to sources outside the United States statutory grouping	43,200
Apportioned to residual grouping	156,800

The total interest expense apportioned to the statutory grouping ($43,200) under the gross income method is 60 percent of the total amount apportioned to the statutory grouping ($72,000) under the asset method. Thus, X may use Option One of the gross income method (paragraph (e)(2)(vi)(A) of this section) and apportion $43,200 of its interest expense to the statutory grouping.

Example (3)—Research and Development—(i) *Facts.* X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawn mowers. Gasoline engines are a product within the category, Machinery, except electrical (SIC Major Group 35). Y, a wholly owned foreign subsidiary of X also manufactures and sells these engines abroad. During 1977, X incurred expenditures of $60,000 on research and development, which it deducts as a current expense, to invent and patent a new and improved gasoline engine. All of the research and development was performed in the United States. In 1977, the domestic sales by X of the new engine total $500,000 and foreign sales by Y total $300,000. X provides technology on the manufacture of engines to Y as a contribution to capital, for which no royalty is paid. In 1977, X's income is $150,000, of which $140,000 is from domestic sales and $10,000 is a dividend from Y.

(ii) *Allocation.* The research and development expenditures were incurred in connection with small gasoline engines and they are definitely related to the items of gross income to which the research gives rise, namely gross income from the sale of small gasoline engines in the United States and dividends received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, the expenses are allocable to this class of gross income.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources without the United States and the residual grouping is gross income from sources within the United States. Since the related class of gross income derived from the use of engine technology consists of both gross income from sources without the United States (dividends from Y) and gross income from sources within the United States (gross income from engine sales), X's deduction of $60,000 for its research and development expenditure must be apportioned between the statutory and residual grouping before the overall limitation may be applied. Because more than 50 percent of X's research and development activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping of gross income, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales by X and Y. Alternatively, X's deduction for research and development can be apportioned under the optional gross income method. The apportionment for 1977 is as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be apportioned between residual and statutory groupings of gross income	$60,000
Less:	
Exclusive apportionment of research and development expense to the residual grouping of gross income: $60,000 × 50 percent	30,000
Research and development expense to be apportioned between residual and statutory groupings of gross income on the basis of sales	30,000
Apportionment of research and development expense to the residual grouping of gross income: $30,000 × [$500,000/($500,000 + $300,000)]	18,750
Apportionment of research and development expense to the statutory grouping of gross income: $30,000 × [$300,000/($500,000 + $300,000)]	11,250
Total: Apportioned deduction for research and development	60,000
Of which—	
Apportioned to the residual grouping ($30,000 + $18,750)	48,750
Apportioned to the statutory grouping	11,250

TENTATIVE APPORTIONMENT ON THE BASIS OF GROSS INCOME

Research and development expense apportioned to sources within the United States (residual grouping): $60,000 × [$140,000/($140,000 + $10,000)]	$56,000
Research and development expense apportioned to sources within country Y (statutory grouping): $60,000 × [$10,000/($140,000 + $10,000)]	4,000
Of which—	
Apportioned to the residual grouping	56,000
Apportioned to statutory grouping	4,000

The total research and development expense apportioned to the statutory grouping ($4,000) under the gross income method is approximately 36 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use Option Two of the gross income method (paragraph (e)(3)(iii)(B) of this section) and apportion to the statutory grouping fifty percent (50%) of the $11,250 apportioned to that grouping under the sales method. Thus, X apportions $5,625 of research and development expense to the statutory grouping.

Example (4)—Research and Development—(i) *Facts.* Assume the same facts as in example (3) except that X also spends $30,000 in 1977 for research on bulldozers, all of of which is performed in the United States, and X has bulldozer sales in the United States of $400,000. X's foreign subsidiary Y neither manufactures nor sells bulldozers. The bulldozer research is in addition to the $60,000 in research which X does on gasoline engines for lawn mowers. X thus has a deduction of $90,000 for its research activity. X's gross income is $200,000, of which $140,000 is from sales of gasoline engines, $50,000 is from sales of bulldozers, and $10,000 is a dividend from Y.

(ii) *Allocation.* X's research expenses generate income from sales of small gasoline engines and bulldozers. Both of these products are in the major broad product category, Machinery, except electrical (SIC Major Group 35). Therefore, the deduction is definitely related to this product category and allocable to all items of income attributable to it, gross income from the sale of small gasoline engines and bulldozers in the United States and dividends from foreign subsidiary Y, a foreign manufacturer and seller of small gasoline engines.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $90,000 must be apportioned between the statutory and residual groupings. Because more than 50 percent of X's research and development activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of total sales by X and Y. Alternatively, X's deduction for research and development can be apportioned under the optional gross income method. The apportionment for 1977, is as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be apportioned between residual and statutory groupings of gross income	$90,000
Less:	
Exclusive apportionment of the research and development expense to the residual grouping of gross income: $90,000 × 50 percent	45,000
Research and development expense to be apportioned between the residual and statutory groupings of gross income on the basis of sales	45,000
Apportionment of research and development expense to the residual grouping of gross income: $45,000 × [($500,000 + $400,000)/($500,000 + $400,000 + $300,000)]	33,750
Apportionment of research and development expense to the statutory grouping of gross income: $45,000 × [$300,000/($500,000 + $400,000 + $300,000)]	11,250
Total: Apportioned deduction for research and development	90,000

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES—Continued

Of which—	
Apportioned to the residual grouping ($45,000 + $33,750)	78,750
Apportioned to the statutory grouping	11,250

TENTATIVE APPORTIONMENT ON THE BASIS OF GROSS INCOME

Research and development expense apportioned to sources within the United States (residual grouping): $90,000 × [$190,000/ ($140,000 + $50,000 + 10,000)]	$85,500
Research and development expense apportioned to sources within country Y (statutory grouping): $90,000 × [$10,000/ ($140,000 + $50,000 + $10,000)]	4,500
Of which—	
Apportioned to the residual grouping	85,500
Apportioned to the statutory grouping	4,500

The total research and development expense apportioned to the statutory grouping ($4,500) under the gross income method is 40 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X, may use Option Two of the gross income method (Paragraph (e)(3)(iii)(B) of this section) and apportion to the statutory grouping fifty percent (50%) of the $11,250 apportioned to that grouping under the sales method. Thus, X apportions $5,625 of research and development expense to the statutory grouping.

Example (5)—*Research and Development*—(i) *Facts.* Assume the same facts as in example (3) except that in 1978 X continues its sales of the new engines, with sales of $600,000 in the United States and $400,000 by subsidiary Y. X also acquires a 60 percent ownership interest in foreign corporation Z and a 100 percent ownership interest in foreign corporation C. X transfers its engine technology to Z for a royalty equal to 5 percent of sales, and X enters into a cost-sharing arrangement with C to share the funding of all of X's research activity. In 1978, corporation Z has sales in country Z equal to $1,000,000. X incurs expense of $80,000 on research and development in 1978, and in addition, X performs $15,000 of research on gasoline engines which was funded by the cost-sharing arrangement with C. All of Z's sales are from the product category, Machinery, except electrical (SIC Major Group 35). X performs all of its research in the United States and $20,000 of its expenditure of $80,000 is made solely to meet noise pollution standards mandated by the United States Government. X establishes, to the satisfaction of the Commissioner, that the expenditure in response to noise pollution standards is not expected to generate gross income (beyond de minimis amounts) outside the United States.

(ii) *Allocation.* The $20,000 of research expense which X incurred in connection with U.S. noise pollution standards is definitely related and thus allocable to the residual grouping, gross income from sources within the United States. The remaining $60,000 in research and development expenditure incurred by X is definitely related to all gasoline engines and is therefore allocable to the class of gross income to which the engines give rise, gross income from sales in the United States, dividends from country Y, and royalties from country Z. No part of the $60,000 research expense is allocable to dividends from country C because corporation C has already paid, through its cost-sharing arrangement, for research activity performed by X which may benefit C.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources within countries Y and Z, and the residual grouping is gross income from sources within the United States. X's deduction of $60,000 for its research and development expenditure must be apportioned between these groupings. Because more than 50 percent of the research and development was performed in the United States, 40 percent (in 1978) of the $60,000 deduction can be apportioned exclusively to the residual grouping. The remaining 60 percent of the deduction can then be apportioned between the residual and the statutory grouping on the basis of sales by X, Y, and Z. (Alternatively X's deduction for research and development can be apportioned under one of the optional gross income methods, which are not illustrated in this example (see instead examples (3) and (4)). Since X has only a 60 percent ownership interest in corporation Z, only 60 percent of Z's sales (60% of $1,000,000, or $600,000) are included for purposes of apportionment. The allocation and apportionment for 1978 is as follows:

X's total research expense	$80,000
Less:	
U.S. Government mandated research directly allocated to the residual grouping of gross income	20,000

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be apportioned between residual and statutory groupings of gross income	$60,000
Less:	
Exclusive apportionment of research and development expense to the residual grouping of gross income: $60,000 × 40 percent	24,000
Research and development expense to be apportioned between the residual and the statutory grouping on the basis of sales	36,000

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES—Continued

Apportionment of research and development expense to gross income from sources within the United States (residual grouping): $36,000 × [$600,000/ ($600,000 + $400,000 + $600,000)]	13,500
Apportionment of research and development expense to gross income from countries Y and Z (statutory grouping): $36,000 × [($400,000 + $600,000)/ ($600,000 + $400,000 + $600,000)]	22,500
Total: Apportioned deduction for research and development ($24,000 + $36,000)	60,000
Of which—	
Apportioned to the residual grouping ($24,000 + $13,500)	37,500
Apportioned to the statutory grouping of sources within countries Y and Z	22,500

Example (6)—Research and Development—(i) *Facts.* X, a domestic corporation, manufactures and sells forklift trucks and other types of materials handling equipment in the United States. The manufacture and sale of trucks and other handling equipment belongs to the product category, Transportation equipment (SIC Major Group 37). X also sells its forklift trucks to a wholesaling subsidiary located in foreign country Y (and title passes in country Y), and X manufactures forklift trucks in foreign country Z. The wholesaling of forklift trucks in country Y belongs to the product category, Wholesale trade (SIC Major groups 50 and 51). X performs no research with respect to wholesale trade. In 1977, X sold $7,000,000 of trucks to purchasers in the United States, $3,000,000 of trucks to the wholesaling subsidiary in Y, and truck components with an FOB export value of $2,000,000 to its branch in Z. The branch's sales of finished trucks were $5,000,000. In response to emission control requirements of the United States Government, X's United States research department has been engaged in a research project to improve the performance and quality of engine exhaust systems used on its products in the United States. It incurs expenses of $100,000 for this purpose in 1977. In the past, X has customarily adapted the product improvements developed originally for the domestic market to its forklift trucks manufactured abroad. During the taxable year 1977, development of an imporved engine exhaust system is completed and X begins installing the new system during the latter part of the taxable year in products manufactured and sold in the United States. X continues to manufacture and sell forklift trucks in foreign countries without the improved engine exhaust systems.

(ii) *Allocation.* X's deduction for its research expense is definitely related to the income to which it gives rise, namely income from the manufacture and sale of forklift trucks within the United States and in country Z. Although the research is undertaken in response to a United States Government mandate, it can reasonably be expected to generate gross income from the manufacture and sale of trucks by the branch in Z. Therefore, the deduction is not allocable solely to income from X's domestic sales of forklift trucks. It is allocable to income from such sales and income from the sales of X's branch in Z. However the deduction for research expense is not allocable to the sales of the subsidiary in Y, because those sales are in a different product category.

(iii) *Apportionment.* For the method of apportionment on the basis of either sales or gross income see example (3). However, in determining the amount of research apportioned to income from foreign and domestic sources, the net sales of the branch in Z are $3,000,000 ($5,000,000 less $2,000,000) and the sales within the United States are $12,000,000 ($7,000,000 plus $3,000,000 plus $2,000,000).

Example (7)—Research and Development—(i) *Facts.* X, a domestic corporation, is a drug company which manufactures a wide variety of pharmaceutical products for sale in the United States. Pharmaceutical products belong to the product category, Chemicals and allied products (SIC Major Group 28). X exports its pharmaceutical products through a domestic international sales corporation (DISC). X's wholly owned foreign subsidiary Y also manufactures pharmaceutical products. In 1977, X has domestic sales of $10,000,000, the DISC has sales of $3,000,000, and Y has sales of $5,000,000. In that same year, 1977, X incures expense of $200,000 on research to test a product in response to requirements imposed by the United States Food and Drug Administration (FDA). X is able to show that, even though country Y imposes certain testing requirements on pharmaceutical products, the research performed in the United States is not accepted by country Y for purposes of its own licensing requirements, and the research has minimal use abroad. X is further able to show that its DISC sells goods to countries which do not accept or do not require research performed in the United States for purposes of their own licensing standards.

(ii) *Allocation.* Since X's research expense of $200,000 is undertaken to meet the requirements of the United States Food and Drug Administration, and since it is reasonable to expect that the expenditure will not generate gross income (beyond de minimis amounts) outside the United States, the deduction is definitely related and thus allocable to the residual grouping.

(iii) *Apportionment.* No apportionment is necessary since the entire expense is allocated to the residual grouping, gross income from sales within the United States.

Example (8)—Research and Development—(i) *Facts.* X, a domestic corporation, is engaged in continuous research and development to improve the quality of the products that it manufactures and sells, which are floodlights, electric fans, television sets, and storage batteries. X incurs and deducts $100,000 of expenditure for research and development in 1977 which was performed exclusively in the United States. As a result of this research activity, X acquires patents which it uses in its own manufacturing activity. X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, countries Y and Z, respectively. Corporation Y pays X an arm's length royalty of $3,000 plus $0.20 for each floodlight sold. Sales of floodlights by Y for the taxable year are $135,000 (at $4.50 per unit) or 30,000 units, and the royalty is $9,000 ($3,000+$0.20×30,000). Y has sales of other products of $500,000. Z pays X an arm's length royalty of $3,000 plus $0.30 for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is $12,000 ($3,000+$0.30×30,000). The dollar value of Z's floodlight sales is not known and cannot be reasonably estimated because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theatres. The sales of all Z's products, including the lighting equipment for theatres, are $1,000,000. Y and Z each sell the floodlights exclusively within their respective countries. X's sales of floodlights for the taxable year are $500,000 and its sales of its other products, fans, televisions, and batteries, are $400,000. X has gross income of $500,000, consisting of gross income from domestic sources of $479,000, and royalty income of $9,000 and $12,000 from foreign corporations Y and Z respectively.

(ii) *Allocation.* X's research and development expenses are definitely related to all of the products that it produces, which are flood lights, electric fans, television sets, and storage batteries. All of these products are in the same broadly defined product category, Electrical and electronic machinery, equipment, and supplies (SIC Major Group 36). Thus, X's research and development expenses are allocable to all items of income attributable to this product category, domestic sales income and royalty income from the foreign countries in which corporations Y and Z operate.

(iii) *Apportionment.* Since X uses the overall limitation for calculating the foreign tax credit, the statutory grouping of gross income is royalty income from countries Y and Z. The residual grouping is gross income from sources within the United States. X's deduction of $100,000 for its research expenditures must be apportioned between the groupings. For apportionment on the basis of sales in accordance with paragraph (e)(3)(ii) of this section, X is entitled (in 1977) to an exclusive apportionment of 50 percent of its research and development expense to the residual grouping, gross income from sources within the United States, since more than 50 percent of the research activity was performed in the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales. Since Y and Z are unrelated licensees of X, only their sales of the licensed product, floodlights, are included for purposes of apportionment. Floodlight sales of Z are unknown, but are estimated at ten times royalties from Z, or $120,000. All of X's sales from the entire product category are included for purposes of apportionment on the basis of sales. Alternatively, X may apportion its deduction on the basis of gross income, in accordance with paragraph (e)(3)(iii) of this section. The apportionment for 1977 is as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be apportioned between statutory and residual groupings of gross income	$100,000
Less:	
Exclusive apportionment of research and development expense to the residual groupings of gross income: $100,000×50 percent	50,000
Research and development expense to be apportioned between the statutory and residual groupings of gross income on the basis of sales	50,000
Apportionment of research and development expense to the residual groupings of gross income: $50,000 × [$900,000/($900,000 + $135,000 + $120,000)]	38,961
Apportionment of research and development expense to the statutory grouping, royalty income from countries Y and Z: $50,000 × [$135,000 + $120,000/($900,000 + $135,000 + $120,000)]	11,039
Total: Apportioned deduction for research and development	100,000
Of which—	
Apportioned to the residual grouping ($50,000+$38,961)	88,961
Apportioned to the statutory grouping of sources within countries Y and Z	11,039

TENTATIVE APPORTIONMENT ON GROSS INCOME BASIS

Apportionment of research and development expense to the residual grouping of gross income:	
$100,000 × ($479,000/$500,000)	$95,800
Apportionment of research and development expense to the statutory grouping, royalty income from Y and Z:	
$100,000 × [($9,000 + $12,000)/$500,000]	4,200
Of which—	
Apportioned to the residual grouping	95,800
Apportioned to the statutory grouping of sources within countries Y and Z	4,200

Since X's apportionment on the basis of gross income to the statutory grouping, $4,200, is less than 50 percent of its apportionment on the basis of sales to the statutory grouping, $11,039 it may use Option Two of paragraph (e)(3)(iii)(B) of this section and apportion $5,520 (50 percent of $11,039) to the statutory grouping.

Example (9)—Research and Development—(i) *Facts.* X, a domestic corporation, manufactures and sells commercial amounts of individual products A, B, and C, each of which is identified with a 7-digit code in the *Numerical List of Manufactured Products,* and all of which are contained in one broad product category, Transportation equipment (SIC Major Group 37). X's wholly owned foreign subsidiary, Y, manufactures and sells commercial amounts of transportation equipment products A, B, and D. X's wholly owned foreign subsidiary Z manufactures and sells commercial amounts of transportation equipment product C. In 1978, X incurs expense of $100,000 on research and development performed in the U.S. and has domestic sales of $5,000,000 of which product A accounts for $2,000,000, product B accounts for $2,500,000, and product C accounts for $500,000. Y has foreign sales of $1,000,000, and Z has foreign sales of $500,000. X challenges the allowable amount of 40 percent of its research and development expenditure that is apportioned exclusively to the residual grouping, gross income from domestic sales. For purposes of apportionment on the basis of sales, X contends that it is entitled to a larger exclusive apportionment because its research has very limited and long delayed application outside the United States. X establishes to the satisfaction of the Commissioner that, while it has regularly licensed Y, Z cannot reasonably be expected to benefit from X's research, either directly or indirectly through X or Y. X further establishes, to the satisfaction of the Commissioner, that the individual products manufactured and sold by Y, namely A and B, which are also manufactured and sold by X account for 90 percent of X's sales (($2,000,000 + $2,500,000)/($5,000,000) = 90 percent); and that there is a delay of about 4.7 years between the time X applies research to its domestic sales and then makes it available to Y.

(ii) *Allocation.* X's research is definitely related to the Transportation equipment product category and thus allocable to all income from that category.

(iii) *Apportionment.* Since X computes the limit on its foreign tax credit under the overall method, there is one statutory grouping, gross income from sources outside the United States, and one residual grouping, gross income from sources within the United States. The research and development deduction is apportioned between these two groupings. In determining whether the 40 percent exclusive apportionment prescribed in paragraph (e)(3)(ii)(A) of this section must be applied to this particular taxpayer, the following analysis is made. In this analysis, Z's sales of product C are ignored.

CALCULATION OF EXCLUSIVE APPORTIONMENT ON BASIS OF PRESCRIBED PERCENTAGE

X's total deduction for research and development	$100,000
Tentative exclusive apportionment of research and development expense to the residual grouping of gross income: $100,000 × 40 pct	40,000

CALCULATION OF EXCLUSIVE APPORTIONMENT ON THE BASIS OF FACTS AND CIRCUMSTANCES

Factor 1:	
Only 90 percent of X's product category is manufactured and sold by foreign subsidiary Y; therefore 10 percent of X's research and development expense should be apportioned exclusively to the residual grouping of gross income: $100,000 × 10 pct	$10,000
Remaining research and development expense: $100,000 − $10,000 = $90,000	
Factor 2:	
There is a delay of 4.7 yr between the time X applies its successful research and development to the domestic market and it is applied by its foreign subsidiary Y; based on a calculation of present value at the safe haven discount rate of 10 pct per year of delay, the contribution of research and development to the delayed foreign sales is approximately 36 pct less than its contribution to domestic sales. Therefore, 36 pct of X's remaining research and development expense should be apportioned exclusively to the residual grouping of gross income: $90,000 × 36 pct	32,400
Total: Exclusive apportionment of research and development expense to the residual grouping based on an analysis of the 2 factors ($10,000 + $32,400)	42,400

The exclusive apportionment to the residual grouping of gross income of $42,400 that is based on an analysis of X's facts and circumstances is not substantially different from the exclusive apportionment of $40,000 provided by the 40 percent exclusive apportionment available to all taxpayers. Since X has not demonstrated facts and circumstances that would justify a substantially different exclusive apportionment than the 40 percent figure, the 40 percent exclusive apportionment stands. The remaining 60 percent of X's research and development expense is apportioned on the basis of total sales of X and Y. (Alternatively, X's deduction for research and development can be apportioned under one of the optional gross income methods, which are not illustrated in this example; see instead examples (3) and (4).)

Example (10)—Research and Development—(i) *Facts.* The facts are the same as example (9), and there are no other material facts except that X establishes to the satisfaction of the Commissioner that foreign subsidiary Y sells 80 percent of the broad product category sold by X; and that there is a delay of about 5.7 years between the time X applies research in generating domestic sales and the time Y applies research in generating foreign sales.

(ii) *Allocation.* X's research is definitely related to the Transportation equipment product category and thus allocable to all income from that category.

(iii) *Apportionment.* Since X computes its foreign tax credit limit under the overall method, there is one statutory grouping, gross income from outside the United States, and one residual grouping, gross income from within the United States. The research and development deduction is apportioned between the two groupings. In determining whether the 40 percent exclusive apportionment must be applied to this particular taxpayer, the following analysis is made.

CALCULATION OF EXCLUSIVE APPORTIONMENT ON BASIS OF PRESCRIBED PERCENTAGE

X's total deduction for research and development	$100,000
Tentative exclusive apportionment of research and development expense to the residual grouping of gross income: $100,000×40 pct	40,000

CALCULATION OF EXCLUSIVE APPORTIONMENT ON BASIS OF FACTS AND CIRCUMSTANCES

Factor 1:	
Only 80 pct of X's product category is manufactured and sold by foreign subsidiary Y; therefore 20 pct of X's research and development expense should be apportioned exclusively to the residual grouping of gross income: $100,000×20 pct	$20,000
Remaining research and development expense: $100,000−$20,000=$80,000	
Factor 2:	
There is a delay of 5.7 yr between the time X applies its successful research and development to the domestic market and the time it is applied by its foreign subsidiary Y; based on a calculation of present value at the safe haven discount rate of 10 pct per yr of delay, the contribution of research and development to the delayed foreign sales is approximately 42 pct less than its contribution to domestic sales. Therefore 42 pct of X's remaining research and development expense should be apportioned exclusively to the residual grouping of gross income: $80,000×42 pct	33,600
Total: Exclusive apportionment of research and development expense to the residual grouping based on an analysis of the 2 factors ($20,000+$33,600)	53,600

The exclusive apportionment to the residual grouping of gross income of $53,600 that is based on an analysis of X's facts and circumstances is substantially different from the exclusive apportionment of $40,000 provided by the 40 percent exclusive apportionment available to all taxpayers. Since X has demonstrated, to the satisfaction of the Commissioner, that its facts and circumstances justify a substantially higher exclusive apportionment, the Commissioner allows X to apportion exclusively $53,600 of its research expenses to the residual grouping, gross income from sources within the United States. The remaining $46,400 of X's research and development expense is apportioned on the basis of total sales, but X's domestic sales are adjusted to exclude sales of those products not sold abroad. Since only 80 percent of X's product category is sold abroad by Y, only 80 percent of X's domestic sales are included in the apportionment. (Alternatively, X's deduction for research and development can be apportioned under one of the optional gross income methods illustrated in examples (3) and (4).) The apportionment for 1978 is as follows:

Research and development expense to be apportioned between residual and statutory groupings of gross income	$100,000
Less:	
Exclusive apportionment of research and development expense to the residual grouping of gross income	53,600
Remaining research and development expense to be apportioned between residual and statutory groupings of gross income on basis of comparable sales	46,400

Apportionment of research and development expense to the residual grouping, gross income from within the United States: $46,400 × [($5,000,000 × .80)/ ($5,000,000 × .80 + $1,000,000)]	37,120
Apportionment of research and development expense to the statutory grouping, gross income from outside the United States: $46,400 × $1,000,000/ ($5,000,000 × .80 + $1,000,000)]	9,280
Total: Apportioned deduction for research and development	100,000
Of which—	
Apportioned to the residual grouping ($53,600 + $37,120)	90,720
Apportioned to the statutory grouping	9,280

Example (11)—Research and Development—(i) ***Facts.*** X, a domestic corporation, and Y, its domestic subsidiary, manufacture and sell computers and other items of office equipment, all of which are contained in one broad product category, Electrical and electronic machinery, equipment and supplies (SIC Major Group 37). Many of the same products are manufactured by X's foreign subsidiary Z (in country Z), using the technology of X or Y, and certain patents are licensed to uncontrolled foreign corporations L and M (in countries L and M respectively). For purposes of justifying an exclusive apportionment in excess of 30 percent in 1979, X seeks to establish that its research has long delayed application outside the United States. Substantially all of X's successful research finds its application in new products. X establishes, to the satisfaction of the Commissioner, that the following table accurately portrays the history of commercial introduction of those particular products which, in the year 1979, were both manufactured in the United States by X or Y, and are either manufactured abroad by Z, or licensed abroad to L or M. In identifying particular products, X is not restricted to the 7-digit products listed in ***Numerical List of Manufactured Products.***

	1969 U.S. sales of X and Y (millions)	Year first commercially manufactured in the United States by X or Y	Year first commercially manufactured abroad by Z, or licensed to L or M	Delay in applying research outside the United States (years)
Product a	$130	1972	1974	2
Product b	90	1974	1979	5
Product c	10	1969	1978	9
Product d	50	1970	1973	3
Sales of products manufactured domestically and abroad	280			
Sales of products not manufactured or licensed abroad	55			
Total sales of X and Y	335			

(ii) ***Allocation.*** X's research is definitely related to the Electrical and electronic machinery, equipment and supplies category, and thus allocable to all income from that category.

(iii) ***Apportionment.*** On the basis of the facts established by X, the average delay between X's application of research findings in the United States and abroad may be estimated as 3.4 years (weighted on the basis of sales):

[(2 yr×$130)+(5 yr×$90)+(9 yr×$10)+(3 yr×$50)]/($130+$90+$10+$50)=3.4 years

If the Commissioner is satisfied that the estimate of 3.4 years accurately reflects the delay between X's application of its research findings in the United States and abroad, such estimate may be accepted for purposes of justifying an exclusive apportionment in excess of 30 percent in 1979.

Example (12)—Research and Development—(i) ***Facts.*** The facts are the same as in example (11) and there are no other material facts except that, in addition to its research on new products, X also conducts research on improving the processes for manufacturing its standard computer components. X is able to establish that, in 1979, its research and development expenses of $7,000,000 may be reasonably divided into $5,000,000 for new product research and $2,000,000 for new process research. (If X is not able to establish clearly the portion of its research expenditures which is attributable to new process research, the determination of an average delay shall be made solely on the basis of the average delay for introducing new products abroad.) X further establishes, to the satisfaction of the Commissioner, that the following table accurately portrays the history of commercial application of previously developed processes which, in 1979, are both used in manufacturing products in the United States by X or Y, and are either used in manufacturing products abroad by Z, or licensed for manufacturing products abroad by L or M.

	1969 U.S. sales of X and Y of products manufactured using the process (millions)	Year process first commercially applied in the United States by X or Y	Year process first commercially applied abroad or licensed to L or M	Delay in applying research outside the United States (years)
Process a	$45	1970	1979	9
Process b	20	1975	1976	1
Process c	60	1975	1972	3

(ii) *Allocation.* X's research on new processes as well as new products is definitely related to the Electrical and electronic machinery, equipment and supplies category, and thus allocable to all income from that category.

(iii) *Apportionment.* On the basis of the facts established by X, the average delay between X's application of research findings to the use of new manufacturing processes in the United States and abroad may be estimated as 2.0 years (weighted on the basis of sales):

[(9 yr×$45)+(1 yr×$20)+(−3 yr×$60)]/($45+$20+$60)=2 years

On the basis of the estimate of an average 2.0 year delay in introducting new processes abroad, and a 3.4 year delay in introducing new products abroad (from Example (11)), and on the basis of the division of research expense between new processes technology ($2,000,000) and new product technology ($5,000,000), the overall delay between X's application of research findings in the United States and abroad may be estimated as 3.0 years:

[(2 yr×$2,000,000)+(3.4 yr×$5,000,000)]/($2,000,000+$5,000,000)=3 years

If the Commissioner is satisfied that the estimate of 3.0 years accurately reflects the delay between X's application of its research findings in the United States and abroad, such estimate may be accepted for purposes of justifying exclusive apportionment in excess of 30 percent in 1979.

Example (13)—Research and Development—(i) *Facts.* X, a domestic corporation, manufactures and sells electronic computer Model A in the United States. X performs research in the United States with particular emphasis on improving the characteristics of its Model A computer. Y, a foreign subsidiary of X, manufactures and sells electronic computer Model B in France. For purposes of justifying an exclusive apportionment in excess of 30 percent in 1979, X seeks to establish that its research has more limited application in France than in the United States. X establishes that the Model A computer works at substantially faster speeds, and otherwise has markedly superior characteristics, than the Model B computer.

(ii) *Allocation.* X's research is definitely related to the Electrical and electronic machinery, equipment and supplies category (SIC Major Group 35), and thus allocable to all income from that category.

(iii) *Apportionment.* Electronic computers are an individual product enumerated as product number 3573100 (electronic computers, except typewriters, peripheral equipment, and parts) in the *Numerical List of Manufactured Products.* The *Numerical List* groups Model A and Model B computers together under the same product heading. On the basis of these facts, X does not have a more limited application of its research in France than in the United States.

Example (14)—Research and Development—(i) *Facts.* X, a domestic corporation, produces a variety of chemical products used in the further manufacture of synthetic fibers, plastics, paints, fertilizers and explosives. Chemical products are in the category, Chemicals and allied products (SIC Major Group 28). X has total sales of its chemical products of $5,000,000 in 1978 and incurs expense of $200,000 on research and development performed in the United States which it deducts as a current expense. In 1978, X licenses unrelated foreign corporation Y to use one of X's chemical patents in the manufacture of chemical A. The research and development leading to this particular patent was performed by X between 1955 and 1960. Corporation Y manufactures and sells chemical A as well as other products in country Y. Y has sales of $500,000 of chemical A in 1978. It pays X a royalty of 2 percent of sales for use of the patent.

(ii) *Allocation.* X's expenditures for research and development are definitely related to the product category, Chemicals and allied products (SIC Major Group 28), and thus allocable to the income related to it, domestic sales income and foreign royalty income.

(iii) *Apportionment.* X computes its foreign tax credit limit under the overall method. The statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United

States. Forty percent of X's deduction for research and development is apportioned exclusively (in 1978) to the residual grouping of gross income since the work was performed in the United States. The remaining 60 percent of the deduction is apportioned between the residual and statutory groupings on the basis of sales by X and Y. Since Y is an uncontrolled licensee of X, only its sales of chemical A are included for purposes of apportionment. (Alternatively, X could apportion its research and development deduction on the basis of one of the gross income optional methods illustrated in examples (3) and (4).) The apportionment, on a sales basis, for 1978 is as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be apportioned between residual and statutory groupings of gross income	$200,000
Less:	
Exclusive apportionment of research and development expense to the residual grouping of gross income: $200,000 × 40 pct	80,000
Research and development expense to be apportioned between residual and statutory groupings on the basis of sales	120,000
Apportionment of research and development expense to the residual grouping of gross income: $120,000 × [$5,000,000 / ($5,000,000 + $500,000)]	109,091
Apportionment of research and development expense to the statutory grouping of gross income: $120,000 × [500,000 / ($5,000,000 + $ 500,000)]	10,909
Total: Apportioned deduction for research and development	200,000
Of which—	
Apportioned to the residual grouping ($80,000 + $109,091)	189,091
Apportioned to the statutory grouping	10,909

Example (15)—Research and Development—(i) ***Facts.*** X, a domestic corporation, manufactures heating equipment. Heating equipment is within the product category, Fabricated metal products, except machinery and transportation equipment (SIC Major Group 34). X incurs expense of $200,000 in 1978 on a successful research project that results in the development of an energy saving furnace. X also incurs expense of $50,000 on basic research which cannot be reasonably related to any product category. All of the research is performed in the United States. X has domestic sales of heating equipment of $500,000 in 1978 on which it earns gross income of $200,000, but has no sales of the new furnace since its production is deferred until 1979. In 1978, X transfers its new furnace technology to uncontrolled foreign corporation Y, which manufactures and sells heating equipment in addition to other fabricated metal products in a foreign country. X receives a lump-sum payment of $25,000 for the sale of the technology. X has a 40 percent ownership interest in Y. The heating equipment sales of Y for 1978 are unknown and cannot be reasonably estimated, but it is known that Y has no sales of the new furnace. X also has a wholly owned foreign subsidiary, Z, which operates hotels in the same foreign country in which Y operates. Hotels are in the product category, other services (SIC Major Groups 70, 72, 73, 75, 76, 78, 79, 80, 81, 82, 83, 84, 86, 88, and 89). X receives $100,000 in dividends from Z in 1978, and Z has receipts of $1,000,000.

(ii) *Allocation.* X's research on heating equipment is definitely related to the product category. Fabricated metal products, except machinery and transportation equipment, and the deduction of $200,000 for research and heating equipment thus is allocable to all items of income related to that product category, domestic sales income and the lump sum technology transfer payment. X's basic research is related to all products and the deduction of $50,000 for basic research thus is allocable to all of X's income.

(iii) *Apportionment.* Since X uses the overall method to compute the limit on its foreign tax credit there is one statutory grouping, gross income from sources outside the United States, and one residual grouping, gross income from sources within the United States. Under the sales method, X can exclusively apportion 40 percent (in 1978) of its deduction for research and development to the residual grouping since more than 50 percent of its research activity was performed in the United States. The rest of the deduction may be apportioned on the basis of sales. Since foreign corporation Y's sales of heating equipment are unknown, they are estimated at 10 times the lump-sum payment of $25,000 made by Y to X for the purchase of the new heating equipment technology, or $250,000. (Alternatively, X may apportion its research expense under one of the optional gross income methods.) The apportionment for 1978 is as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF SALE

Research and development expense on furnace to be apportioned between residual and statutory groupings of gross income	$200,000
Less:	
Exclusive apportionment of research and development expense on furnace to the residual grouping of gross income: 1$200,000 × 40 pct	80,000

Tentative Apportionment on the Basis of Sale—Continued

Research and development expense on furnace to be apportioned between residual and statutory groupings of gross income on the basis of sales	120,000
Apportionment of research and development expense on furnace to the residual grouping of gross income: $120,000 × [$500,000/($500,000 + $250,000)]	80,000
Apportionment of research and development expense on furnace to the statutory grouping of gross income: $120,000 × [$250,000/($500,000 + $250,000)]	40,000
Total: Apportioned deduction for research and development on furnace	200,000
Basic research expense to be apportioned between residual and statutory groupings of gross income	50,000
Less:	
Exclusive apportionment of basic research to the residual grouping of gross income: $50,000 × 40 pct	20,000
Basic research to be apportioned between residual and statutory groupings of gross income on the basis of sales	30,000
Apportionment of basic research expense to the residual grouping of gross income: $30,000 × [$500,000/($500,000 + $250,000 + $1,000,000)]	8,571
Apportionment of basic research expense to the statutory grouping of gross income: $30,000 × [($250,000 + $1,000,000)/($500,000 + $250,000 + $1,000,000)]	21,429
Total: Apportioned deduction for basic research	30,000
Total: Apportioned deduction for research and development on furnace and basic research	250,000
Of which—	
Apportioned to the residual grouping ($80,000 + $80,000 + $20,000 + $8,571)	188,571
Apportioned to the statutory grouping ($40,000 + $21,429)	61,429

Tentative Apportionment on the Basis of Gross Income

Apportionment of research and developmental expense to the residual grouping of gross income: $250,000 × [$200,000/($200,000 + $25,000 + $100,000)]	$153,846
Apportionment of research and development expense to the statutory grouping of gross income: $250,000[($25,000 + $100,000)/($200,000 + $25,000 + $100,000)]	96,154

The apportionment to the statutory grouping under the gross income method ($96,154) is greater than 50 percent of the apportionment under the sales method ($30,714). Thus, X may apportion either the amount determined under the optional gross income method or the amount determined under the sales method to the statutory grouping.

In either case, X's apportionment to the statutory grouping exceeds its lump-sum receipt for the sale of technology and must be partly applied against its dividends from Z.

Example (16)—Research and Development—(i) *Facts.* X, a domestic corporation, is a manufacturer of roller bearings for use in bicycles. Roller bearings are within the product category, Machinery, except electrical (SIC Major Group 35). In 1977, X performs research and development in the United States in an attempt to develop an improved roller bearing suitable for use in racing bicycles. X incurs expense of $50,000 for this purpose and deducts this amount as a current expense. In 1977, X has domestic roller bearing sales of $500,000. X's wholly owned subsidiaries, Y and Z, also manufacture and sell roller bearings in foreign country Y and Puerto Rico, respectively, and can reasonably be expected to benefit from X's research connected with Machinery, except electrical. Corporation Y performs certain preliminary manufacturing activity for corporation Z which, in turn, finishes the manufacturing work on the roller bearings purchased from Y. In 1977, Y has total roller bearings sales of $500,000, $250,000 in country Y and $250,000 to corporation Z in Puerto Rico. Corporation Z has roller bearing sales of $400,000 in the same year.

(ii) *Allocation.* The research and development expenditures were incurred in connection with the manufacture of roller bearings. Thus, they are definitely related and allocable to the income to which they give rise, namely income from the manufacture and sale of roller bearings in the United States, country Y, and Puerto Rico.

(iii) *Apportionment.* For purposes of applying the per-country limitation, the statutory groupings are gross income from manufacturing in country Y and Puerto Rico, and the residual grouping is gross income from manufacturing within the United States. X's deduction must be apportioned between these three groupings. Because more than 50 percent of X's research and development activity was performed in the United States, for purposes of apportionment on the basis of sales, 50 percent of that deduction is apportioned exclusively (in 1977) to the residual grouping, gross income from within the United States. The remainder of the deduction can be apportioned on the basis of sales of X, Y, and Z. In calculating the apportionment, however, the purchases of Z from corporation Y are subtracted from Z's sales. For purposes of apportionment, Z's sales are $150,000 ($400,000 less $250,000). The apportionment for 1977 is as follows:

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be apportioned between residual and statutory groupings of gross income	$50,000
Less:	
Exclusive apportionment of research and development expense to the residual grouping of gross income: $50,000 × 50 pct	25,000
Research and development expense to be apportioned between residual and statutory groupings of gross income on the basis of sales	25,000
Apportionment of research and development expense to the residual grouping of gross income: $25,000 × [$500,000/($500,000 + $500,000 + $150,000)]	10,870
Apportionment of research and development expense to the statutory grouping, gross income from country Y: $25,000 × [$500,000/($500,000 + $500,000 + $150,000)]	10,870
Apportionment of research and development expense to the statutory grouping, gross income from Puerto Rico: $25,000 × [($400,000 − $250,000)/($500,000 + $500,000 + $150,000)]	3,260
Total: Apportioned deduction for research and development	50,000
Of which—	
Apportioned to the residual grouping ($25,000 + $10,870)	35,870
Apportioned to the statutory grouping to sources within country Y	10,870
Apportioned to the statutory grouping of sources within Puerto Rico	3,260

(Alternatively, X could apportion its research and development expense using one of the optional gross income methods in accordance with paragraph (e)(3)(iii) of this section.)

Example (17)—Stewardship Expenses (Consolidation)—(i) *Facts.* X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000
O	50,000	20,000
Total	550,000	370,000

Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitute stewardship expenses. The remainder of X's deductions ($20,000) relates to production of income from its plant in the United States.

(ii) *Allocation.* In accordance with § 1.1502-4, each corporation must first compute its separate taxable income for purposes of computing the limitation on the foreign tax credit. X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to income earned from sources without the United States and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the overall limitation, the statutory grouping is gross income from sources without the United States and the residual grouping is gross income from sources within the United States. As a result of the allocation of deductions, X, M, and N have separate taxable income (losses) from sources without the United States in the amounts of ($25,000), $150,000, and ($50,000), respectively, computed as follows:

	X	M	N
Foreign gross income		$250,000	$150,000
Less: Deductions allocable to foreign gross income	$25,000	100,000	200,000
Total, taxable income (loss)	(25,000)	150,000	(50,000)

Thus, in the combined computation of the overall limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000 ($150,000 of separate taxable income of M less $50,000 of losses of N and less $25,000 of losses of X).

Example (18)—Stewardship and Supportive Expenses—(i) *Facts.* X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year. X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S (before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000
Fees from U for services performed in the United States	1,000,000
Total gross income	40,000,000
Among other deductions, X incurs the following:	
Expenses of supervision department	1,600,000
Charitable contributions	100,000

X's Supervision Department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $1,000,000. The second type consists of stewardship activities which are in the nature of a management review and generally duplicate functions performed by the subsidiaries' own employees (and are, therefore, of a type described in § 1.482-2(b)(2)(ii) which would not be subject to an allocation under section 482). For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) *Allocation.* The Department's outlay of $1,000,000 is the basis for the charge to U for services rendered, and therefore $1,000,000 is allocated to the fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U and V and royalties from t and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary serivces and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Supervision Department expenses and related supportive expenses which is allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the overall limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

The gross receipts of the subsidiaries were as follows:

S	$4,000,000
T	3,000,000
U	500,000
V	1,500,000
Total	9,000,000

Thus, the expenses of the Department are apportioned for purposes of the overall limitation as follows:

Apportionment of stewardship expenses to the statutory grouping of gross income: 540,000 × [($3,000,000 + $500,000 + $1,500,000)/ $9,000,000]	$300,000
Apportionment of supervisory expenses to the residual grouping of gross income: $540,000 × $4,000,000/9,000,000	240,000
Total: Apportioned stewardship expense	540,000

(iv) *Allocation and apportionment of charitable contributions.* Pursuant to paragraph (e)(9) of this section, charitable contributions are generally treated as deductions which are not definitely related to any gross income and are, accordingly, apportioned ratably on the basis of gross income for purposes of the overall limitation as follows:

Apportionment of charitable contributions to the statutory grouping of gross income: $100,000 × [($2,000,000 + $1,000,000 + $1,000,000)/$40,000,000]	$10,000
Apportionment of charitable contributions to the residual grouping of gross income: $100,000 × [($32,000,000 + $3,000,000 + $1,000,000)/$40,000,000]	90,000
Total apportioned charitable contributions	100,000

Example (19)—Supportive Expense—(i) *Facts.* X, a domestic corporation, purchases and sells products both in the United States and in foreign countries. X has no foreign subsidiary and no international department. During the taxable year, X incurs the following expenses with respect to its worldwide activities:

Personnel department expenses	$50,000
Training department expenses	35,000
General and administrative expenses	55,000
President's salary	40,000
Sales manager's salary	20,000
Total	200,000

X has domestic gross receipts from sales of $750,000 and foreign gross receipts from sales of $500,000 and has gross income from such sales in the same ratio, namely $300,000 from domestic sources and $200,000 from foreign sources.

(ii) *Allocation.* The above expenses are definitely related and allocable to all of X's gross income derived from both domestic and foreign markets.

(iii) *Apportionment.* For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deductions for its worldwide sales activities must be apportioned between these groupings. Company X in this example (unlike Company X in example (18)) does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the $200,000 deduction is as follows:

Apportionment of the $200,000 expense to the statutory grouping of gross income: $200,000 × [$500,000/($500,000 + $750,000)]	$80,000
Apportionment of the $200,000 expense to the residual grouping of gross income: $200,000 × [$750,000/($500,000 + $750,000)]	120,000
Total apportioned supportive expense	200,000

Example (20)—Supportive Expense—(i) *Facts.* Assume the same facts as above except that X's president devotes only 5 percent of his time to the foreign operations and 95 percent of his time to the domestic operations and that X's sales manager devotes approximately 10 percent of his time to foreign sales and 90 percent of his time to domestic sales.

(ii) *Allocation.* The expenses incurred by X with respect to its worldwide activities are definitely related, and therefore allocable to X's gross income from both its foreign and domestic markets.

(iii) *Apportionment.* On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

Apportionment of the $200,000 expense to the statutory grouping of gross income:	
President's salary: $40,000 × 5 pct	$2,000
Sales manager's salary: $20,000 × 10 pct	2,000
Remaining expenses: $140,000 × [$500,000/($500,000 + $750,000)]	56,000
Subtotal: Apportionment of expense to statutory grouping	60,000
Apportionment of the $200,000 expense to the residual grouping of gross income:	
President's salary: $40,000 × 95 pct	38,000
Sales manager's salary: $20,000 × 90 pct	18,000
Remaining expenses: $140,000 × [$750,000/($500,000 + $750,000)]	84,000
Subtotal: Apportionment of expense to residual grouping	140,000
Total: Apportioned general and administrative expense	200,000

Example (21)—Supportive Expense—(i) *Facts.* X, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. X has no United States subsidiaries and no separate division to manage and oversee its business in the United States. X manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are X's only source of income. In 1977, X incurs general and administrative expenses related to both its U.S. and foreign operations of $100,000. It has machine sales of $500,000, $1,000,000 and $1,000,000 on which it earns gross income of $200,000, $400,000 and $400,000 in the United States, country A, and country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with X's business in the United States.

(ii) *Allocation.* The $100,000 of general and administrative expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in country A, and in country B. The expenses are allocable to this class of income, even though X's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(iii) *Apportionment* Since X is a foreign corporation, the statutory grouping is gross income effectively connected with X's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts which would require a method of apportionment other than on the basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

Apportionment of general and administrative expense to the statutory grouping, gross income from sources within the United States: $100,000 × [$200,000/($200,000 + $400,000 + $400,000)]	$20,000
Apportionment of general and administrative expense to the residual grouping, gross income from sources without the United States: $100,000 × [($400,000 + $400,000)/($200,000 + $400,000 + $400,000)]	80,000
Total apportioned general and administrative expense	100,000

Example (22)—Domestic International Sales Corporations—(i) *Facts.* X, a domestic corporation, manufactures a line of kitchenware and sells it to retailers in the United States, France, and the United Kingdom. After the Domestic International Sales Corporation (DISC) legislation was passed in 1971, X established, as of January 1, 1972, a DISC and thereafter did all of its foreign marketing through sales by the DISC. In 1977 the DISC has total sales of $7,700,000 for which X's cost of goods sold is $6,000,000. Thus, the gross income attributable to exports through the DISC is $1,700,000 ($7,700,000 − $6,000,000). Moreover, X has U.S. domestic sales of kitchenware of $12,000,000 on which it earned gross income of $900,000, and X receives royalty income from the foreign license of its kitchenware technology in the amount of $800,000. The DISC's expenses attributable to the resale of export property are $400,000 of which $300,000 qualify as export promotion expenses. X also incurs $125,000 of general and administrative expenses in connection with its domestic and foreign sales activities, and its foreign licensing activities. X and the DISC determine transfer prices charged on the basis of a single product grouping and the "50-50" combined taxable income method (without marginal costing) which permits the DISC to have a taxable income equal to 50 percent of the combined taxable income attributable to the production and sales of the export property, plus 10 percent of the DISC's export promotion expenses.

(ii) *Allocation.* For purposes of determining combined taxable income of X and the DISC from export sales, general and administrative expenses of $125,000 must be allocated to and apportioned between gross income resulting from the production and sale of kitchenware for export, and from the production and sale of kitchenware for the domestic market. The deduction of $400,000 for expenses attributable to the resale of export property is allocated solely to gross income from the production and sale of kitchenware in foreign markets.

(iii) *Apportionment.* Apportionment of expense takes place in two stages. In the first stage, for computing conbined taxable income from the production and sale of export property, the general and administrative expense should be apportioned between the statutory grouping of gross income from the export of kitchenware and the residual grouping of gross income from domestic sales and foreign licenses. In the second stage, since the limitation on the foreign tax credit requires the use of a separate limitation with respect to dividends from a DISC (section 904(d)), the general and administrative expense should be apportioned between two statutory groupings, DISC dividends and foreign royalty income (for which the overall limitation is used), and the residual grouping of gross income from sales within the United States. In the first stage, in the absence of more specific or contrary information, the general and administrative expense may be apportioned on the basis of gross income in the respective groupings, as follows:

Apportionment of general and administrative expense to the statutory grouping, gross income from exports of kitchenware: $125,000 × [$1,700,000/($1,700,000 + $900,000 + $800,000)]	$62,500
Apportionment of general and administrative expense to the residual grouping, gross income from domestic sales of kitchenware and foreign royalty income from licensing kitchenware technology: $125,000 × [($900,000 + $800,000)/($1,700,000 + $900,000 + $800,000)]	62,500
Total apportionment of general and administrative expense	125,000

On the basis of this apportionment, the combined taxable income, and the DISC portion of taxable income may be calculated as follows:

Gross income from exports	$1,700,000	
Less:		
DISC expense for resale of export property	400,000	
Apportioned general and administrative expense	62,500	
		$462,500
Combined taxable income from production and export of kitchenware		1,237,500
DISC income:		
50 pct of combined taxable income		618,750
10 pct of export promotion expense of $300,000		30,000
Total DISC income		648,750
DISC income as a percentage of combined taxable income		52.4

In the second stage, in the absence of more specific or contrary information, the general and administrative expense may also be apportioned on the basis of gross income in the respective groupings. Since DISC taxable income is 52.4 percent of combined taxable income, DISC gross income is treated as 52.4 percent of the gross income from exports $1,700,000. The apportionment follows:

Apportionment of general and administrative expense to the statutory grouping, DISC dividends: $125,000 × [(0.524 × $1,700,000)/($1,700,000 + $900,000 + $800,000)]	$32,750
Apportionment of general and administrative expense to the statutory grouping, foreign royalty income: $125,000 × [$800,000/($1,700,000 + 900,000 + $800,000)]	29,412
Apportionment of general and administrative expense to the residual grouping, gross income from sources within the United States: $125,000 × [($900,000 + (0.476 × $1,700,000))/($1,700,000 + $900,000 + $800,000)]	62,838
Total apportioned general and administrative expense	125,000

Example (23)—Domestic International Sales Corporations—(i) *Facts.* The facts are the same as in example (22), except that X also performs research, entirely within the United States, on the kitchenware it manufactures. In 1977, X incurs research expense of $100,000. Of this amount, $10,000 is incurred to meet product safety standards imposed by the U.S. Government. Similar safety standards are imposed by the countries to which X's DISC sells exports, and X's research is acceptable for purposes of meeting the standards of those countries. However, the safety research is not relevant for X's foreign licensees. X is able to establish, on the basis of its facts and circumstances (see example (10)) that an exclusive apportionment of $65,000 of its research and development expense to gross income from sources within the United States is appropriate. X does not know, and a reasonable estimate cannot be made, of the sales of licensed products by its foreign licensees. The sales of the foreign licensees are therefore estimated at ten times the amount of royalty income of $800,000 or $8,000,000.

(ii) *Allocation.* The kitchenware manufactured by X is in the broadly defined product category. Fabricated metal products, except machinery and transportation equipment (SIC Major Group 34). X's deduction for safety research is allocable solely to groupings of gross income within the United States, namely gross income from export sales (through the DISC) and gross income from domestic sales. The remainder of X's deductions for its research expense are definitely related and therefore allocable to all items of income attributable to this product category, domestic and foreign sales income, and foreign licensing income. For purposes of determining the combined taxable income of X and its DISC, X and the DISC are treated as a single taxpayer engaged in the production and sale of fabricated metal products. The DISC is not, for this purpose, treated as a separate taxpayer engaged in wholesale trade (SIC Major Groups 50 and 51).

(iii) *Apportionment.* X's deduction for safety research ($10,000) must be apportioned between the statutory grouping of gross income from exports and the residual grouping of gross income from sales within the United States. The deduction for safety research may be apportioned either on the basis of sales (paragraph (e)(3)(ii) of this section) or on the basis of one of the optional gross income methods (paragraph (e)(3)(iii) of this section). X apportions this deduction on the basis of sales. For this purpose an exclusive apportionment is not available, since gross income from exports through a DISC and gross income from sales within the United States are both within the same geographic source, United States income (see paragraph (e)(3)(ii)A) of this section). The remainder of X's research expense ($90,000) must be apportioned in two stages. In the first stage, for combined taxable income purposes, this amount must be apportioned between the statutory grouping of gross income from exports and other gross income. In the second stage, the remainder of X's research expense must be apportioned, for foreign tax credit purposes, between two statutory groupings, DISC dividends and foreign royalty income, respectively, and the residual grouping of gross income from sales within the United States. On the basis of X's facts and circumstances, $65,000 is apportioned exclusively to sources within the United States, namely gross income from exports through a DISC and gross income from sales within the United States. The remaining $25,000 of research expense is apportioned between the groupings of gross income on the basis of sales. (Alternatively, if X had apportioned the $10,000 for safety research on the basis of gross income, its remaining deduction of $90,000 for research expense could be apportioned, both in the first and second stage, using one of the optional gross income methods, which are not illustrated in this example (see instead examples (3) and (4).)

TENTATIVE APPORTIONMENT ON THE BASIS OF SALES

Research and development expense to be allocated and apportioned between residual and statutory groupings of gross income		$100,000
Research and development expense for safety purposes allocated solely to income from sources within the United States: Apportionment of safety research to the residual grouping, gross income from domestic sales: $10,000 × [$12,000,000/($12,000,000 + $7,700,000)]	6,091	
Apportionment of safety research to the statutory grouping, gross income from exports: $10,000 × [$7,700,000/($12,000,000 + $7,700,000)]	3,909	
Total apportioned safety research		10,000
Remaining research and development expense to be apportioned between the residual and statutory groupings of gross income		90,000
Apportionment of remaining research to the residual grouping, gross income from domestic sales and foreign royalties: $90,000 × [($12,000,000 + $8,000,000)/($12,000,000 + $8,000,000 + $7,700,000)]		64,982
Apportionment of remaining research to the statutory grouping, gross income from exports: $90,000 × [$7,700,000/($12,000,000 + $8,000,000 + $7,700,000)]		25,018
Total: Allocated and apportioned deduction for research and development for combined taxable income purposes		100,000
Of which—		
Apportioned to the residual grouping, gross income from domestic sales and foreign royalties ($6,091 + $64,982)		71,073
Apportioned to the statutory grouping, gross income from exports ($3,909 + $25,018)		28,927

On the basis of this apportionment, the combined taxable income and the DISC portion of taxable income may be calculated as follows:

Gross income from exports		$1,700,000
Less:		
DISC expense for resale of export property	$400,000	
Apportioned general and administrative expense (from example (22))	62,500	
Apportioned safety research	3,909	
Apportioned remaining research	25,018	
		491,427
Combined taxable income from production and export of kitchenware		1,208,573
DISC income:		
50 pct of combined taxable income		604,287
10 pct of export promotion expense of $300,000		30,000
Total, DISC income		634,287

In the second stage, the remainder of X's research expense ($90,000) must be apportioned, for foreign tax credit purposes, between two statutory groupings, DISC dividends and foreign royalty income, respectively, and the residual grouping of gross income from sales within the United States.

Remaining research and development expense to be apportioned between the residual and statutory groupings of gross income	$90,000
Less:	
Exclusive apportionment of remaining research and development expense to residual grouping, gross income from domestic sales (based on X's facts and circumstances	65,000
Remaining research and development expense to be apportioned between the residual and statutory groupings on the basis of sales	25,000
Apportionment of research and development expense to the residual grouping of gross income from domestic sales: $25,000 × [$12,000,000/($12,000,000 + $7,700,000 + $8,000,000)]	10,830
Apportionment of research and development expense to the statutory grouping of DISC dividends: $25,000 × [$12,000,000/($12,000,000 + $7,700,000 + $8,000,000)]	6,950

Apportionment of research and development expense to the statutory grouping of foreign royalty income: $25,000 × [$8,000,000/ ($12,000,000 + $7,700,000 + $8,000,000)]	7,220
Total: Allocated and apportioned deduction for research and development for foreign tax credit purposes	100,000
Of which—	
Apportioned to the residual grouping ($6,091 + $65,000 + $10,830)	81,921
Apportioned to the statutory grouping of gross income from exports ($3,909 + $6,950)	10,859
Apportioned to the statutory grouping of foreign royalty income	7,220

Example (24)—Exempt, excluded, or eliminated income—(i) *Facts.* X, a domestic corporation, carries on a trade or business in the United States. In addition, X owns tax exempt municipal bonds, and all the shares of C, a Canadian corporation with which it files a consolidated return under the provisions of section 1504(d). X has gross income from domestic sources of $2,400,000 and tax exempt interest of $100,000. X receives dividends from C of $3,700,000 and interest from C of $50,000. X's dividends from C are eliminated income by virtue of the filing of the consolidated return. The deductible portion of X's interest expense is $500,000 (in addition X has interest expense relating to its tax exempt bonds which is not deductible under section 265) and X has stewardship expense relating to its ownership of C of $100,000. X and C use the overall limitation for purposes of computing the foreign tax credit.

(ii) *Allocation.* No portion of X's interest deduction is definitely related solely to specific property within the meaning of paragraph (e)(2)(iv) of this section. Thus, X's deduction for interest is related to all its income producing activities and properties. X's stewardship expense is related solely to its ownership of C and is therefore allocated to the statutory grouping of foreign source income, namely dividends and interest from C.

(iii) *Apportionment.* X apportions its interest expense using the optional gross income method prescribed in paragraph (e)(2)(vi)(A) of this section. For this purpose, tax exempt and eliminated income is included in gross income. X would therefore apportion its interest deduction between the statutory grouping of foreign source income and the residual grouping as follows:

To gross income from sources within the United States (residual grouping): $500,000 × [($2,400,000 + $100,000)/ ($2,400,000 + $100,000 + $3,700,000 + $50,000)]	$200,000
To gross income from sources without the United States (statutory grouping): $500,000 × [($3,700,000 + $50,000)/ ($2,400,000 + $100,000 + $3,700,000 + $50,000)]	300,000
Total apportioned interest expense	500,000

As a result of the allocation of stewardship expense and the apportionment of interest expense, X's taxable foreign source income is calculated as follows:

Gross income from foreign sources	3,750,000
Less: dividends received deduction	3,700,000
Less: allocation of stewardship expense	100,000
Less: apportionment of interest expense	300,000
Taxable foreign source income (loss)	(350,000)

The amount of interest expense apportioned to tax exempt income for purposes of deductibility is determined not under section 861 but under section 265.

Example (25)—Income Taxes—(i) *Facts.* X, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in individual states, A, B, and C. X also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In 1977, X has taxable income, as determined under the Code, of $1,000,000 of which $200,000 is foreign source taxable income (computed without regard to the deduction for state taxes) and $800,000 is domestic source taxable income (computed assuming, for the moment, that the entire deduction for state taxes is attributable to domestic sources). States A, B, and C each determine X's taxable income for their respective state tax purposes by making adjustments to its taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of relative amounts of payroll, property, and sales with respect to activities and properties within each state as compared to all activities and properties. On this basis, it is determined that X has taxable income of $500,000, $200,000 and $200,000 in states A, B, and C, respectively. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income, as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income, as determined under the Code. Since the corporate tax rates in states A, B, and C are 10 percent, 5 percent, and 2 percent, respectively, X has total state income tax liabilities of $64,000 ($50,000 + $10,000 + $4,000) which it deducts as an expense for Federal income tax purposes.

(ii) *Allocation.* X's deduction of $64,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Presumptively, states A, B, and C only attempt to tax income from domestic sources. However, since the statutes of states A, B, and C do not specifically exempt foreign source income, as determined under the Code, from taxation and since, in the aggregate, states A, B, and C tax $900,000 of X's income while only $800,000 is domestic source income, it is presumed that state income taxes are imposed on at least $100,000 of foreign source income. The deduction for state income taxes is therefore related and allocable both to X's domestic and to its foreign income-producing activities and properties.

(iii) *Apportionment.* Since X computes its foreign tax credit limitation under the overall method there is one statutory grouping, gross income from sources outside the United States, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $64,000 must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of relative amounts of taxable income reached by state taxation. In this case, state income taxes are imposed on $800,000 of domestic source income and $100,000 of foreign source income.

State income tax deduction apportioned to sources outside the United States (statutory grouping): $64,000 × $100,000/$900,000	$7,111
State income tax deduction apportioned to sources within the United States (residual grouping): $64,000 × $800,000/$900,000	56,889
Total apportioned State income tax deduction	64,000
Of which—	
Apportioned to statutory grouping	7,111
Apportioned to residual grouping	56,889

Example (26)—Income Tax—(i) *Facts.* Assume the same facts as in example (25) except that state A's statute exempts all foreign source income, as determined under the Code.

(ii) *Allocation.* X's deduction of $64,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by its statute, its taxes of $50,000 are allocable solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since States B and C impose tax on $400,000 ($200,000 + $200,000) of X's income, of which only $300,000 ($800,000 − $500,000) is domestic source, the deduction for the state income taxes of B and C are related and allocable both to X's foreign and domestic taxable income.

(iii) *Apportionment.* Since X computes its foreign tax credit limitation under the overall method there is one statutory grouping, gross income from sources outside the United States, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $14,000 attributable to states B ($10,000) and C ($4,000) must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of relative amounts of taxable income.

States B and C income tax deduction apportioned to sources outside the United States (statutory grouping): $14,000 × $100,000/$400,000	$3,500
States B and C income tax deduction apportioned to sources within the United States (residual grouping): $14,000 × $300,000/$400,000	10,500
Total apportioned State income tax deduction	14,000
Of which—	
Apportioned to statutory grouping	3,500
Apportioned to residual grouping	10,500

(Secs. 882(c) and 7805 of the Internal Revenue Code of 1954 (80 Stat. 1556; 26 U.S.C. 882(c) and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7456, 42 FR 1195, Jan. 6, 1977, as amended by T.D. 7749, 46 FR 1683, Jan. 7, 1981]

§ 1.861-9 Income from certain aircraft or vessels.

(a) *General rule.* A taxpayer who owns an aircraft or vessel described in paragraph (b) of this section and who leases the aircraft or vessel to a United States person (other than a member of the same controlled group of corporations (as defined in section 1563) as the taxpayer) may elect under paragraph (f) of this section to treat all amounts includible in gross income with respect to the aircraft or vessel as income from sources within the United States for any taxable year ending after the commencement of the lease. This paragraph (a) applies only with respect to taxable years ending after August 15, 1971, and only with respect to leases entered into after that date. An election once made applies to the taxable year for which made and to all subsequent taxable years unless it is revoked or terminated in accordance with paragraph (g) of this section. A taxpayer need not be a United States person to be eligible to make the election under this section, unless otherwise required by a provision of law not contained in the Internal Revenue Code of 1954. In addition, the taxpayer need not be a bank or other financial institution to be eligible to make this election. The term "United States person" as used in this section has the meaning assigned to it by section 7701(a)(30).

(b) *Property to which the election applies*—(1) *section 38 property.* An election made under this section may be made only if the aircraft or vessel is section 38 property, or property which would be section 38 property but for section 48(a)(5) (relating to property used by governmental units), at the time the election is made and for all taxable years to which the election applies. The aircraft or vessel must be property which qualifies for the investment credit under section 38 unless the property does not qualify because it is described in section 48(a)(5). If an aircraft is used predominantly outside the United States (determined under § 1.48-1(g)(1)), it must qualify under the provisions of section 48(a)(2)(B)(i) and § 1.48-1(g)(2)(i). If a vessel is used predominantly outside the United States, it must qualify under the provisions of section 48(a)(2)(B)(iii) and § 1.48-1(g)(2)(iii). The aircraft or vessel may not be suspension or termination period property described in section 48(h) or section 49(a) (as in effect before the enactment of the Revenue Act of 1978). See paragraph (g) (3) and (4) of this section for rules which apply if the property ceases to be section 38 property.

(2) *United States manufacture or construction.* An election under this section may be made only if the aircraft or vessel is manufactured or constructed in the United States. The aircraft or vessel will be considered to be manufactured or constructed in the United States if 50 percent or more of the basis of the aircraft or vessel is attributable to value added within the United States.

(3) *Exclusion of certain property used outside the United States.* The term "aircraft or vessel" as used in this paragraph (b) does not include any property which is used predominantly outside the United States and which qualifies as section 38 property under—

(i) Section 48(a)(2)(B)(v), relating to containers used in the transportation of property to and from the United States,

(ii) Section 48(a)(2)(B)(vi), relating to certain property used for the purpose of exploring for, developing, removing, or transporting resources from the Outer Continental Shelf, or

(iii) Section 48(a)(2)(B)(x), relating to certain property used in international or territorial waters.

(c) *Leases or subleases to which the election applies.* At the time the election under this section is made and for all taxable years for which the election applies, the lessee of the aircraft or vessel must be a United States person. In addition, the aircraft or vessel may not be subleased to a person who is not a United States person unless the sublease is a short-term sublease. For purposes of this section, a short-term sublease is a sublease for a period of time (including any period for which the sublease may be renewed or extended) which is less than 30 percent of the asset guideline period of the aircraft or vessel leased (determined under section 167(m)). See paragrah (g) (3) and (4) of this section for rules which apply if the requirements of this paragraph (c) are not met.

(d) *Income to which the election applies.* An election under this section applies to all amounts derived by the taxpayer with respect to the aircraft or vessel which is subject to the election. The election applies to all amounts which are includible in the taxpayer's gross income whether or not includible during or after the period of a lease to which the election applies. Amounts derived by the taxpayer with respect to the aircraft or vessel include any gain from the sale, exchange, or other disposition of the aircraft or vessel. If by reason of the allowance of expenses and other deductions, there is a loss with respect to an aircraft or vessel, the election applies to treat the loss as having a source within the United States. Similarly, if the sale, exchange or other disposition of the aircraft or vessel which is subject to an election results in a loss, it is treated as having a source within the United States. See paragraph (e)(2) of this section for the application of an election under this section to the income of certain transferees or distributees.

(e) *Effect of election*—(1) *In general.* An election under this section applies to the taxable year for which it is made and to all subsequent taxable years for which amounts in respect of the aircraft or vessel to which the election relates are includible in gross income. However, the election may be revoked under paragraph (g) (1) or (2) of this section or terminated under paragraph (g)(3) of this section.

(2) *Certain transfers involving carryover of basis.* (i) If an electing taxpayer transfers or distributes an aircraft or vessel which is subject to the election under this section, the transferee or distributee will be treated as having made an election under this section with respect to the aircraft or vessel if the basis of the aircraft or vessel in the hands of the transferee or distributee is determined by reference to its basis in the hands of the transferor or distributor. This paragraph (e)(2)(i) applies even though the transferor or distributor recognizes an amount of gain which increases basis in the hands of the transferee or distributee and even though the transferee of distributee is a nonresident alien individual or foreign corporation. For example, if a corporation distributes a vessel which is subject to an election under this section to its parent corporation in a complete liquidation described in section 332(b), the parent corporation will be required to treat all amounts includible in its gross income with respect to the vessel as income from source within the United States if, unless the election is revoked or terminated under paragraph (g) of this section, the basis of the property in the hands of the parent is determined under section 334(b)(1) (relating to the general rule on carryover of basis). In further illustration, if a corporation distributes a vessel (subject to an election) in a distribution to which section 301(a) applies, the distributee will be treated as having made the election with respect to the vessel if its basis is determined under section 301(d)(2) (relating to basis of corporate distributees) even though the basis is the fair market value of the vessel under section 301(d)(2)(A).

(ii) If a member of an affiliated group which files a consolidated return transfers an aircraft or vessel subject to an election to another member of that group, the transferee will be treated as having made the election with respect to the aircraft or vessel. In addition, if a partnership distributes an aircraft or vessel subject to an election to a partner, the partner will be treated as having made the election with respect to the aircraft or vessel.

(iii) If paragraph (e)(2) (i) and (ii) of this section do not apply, the election under this section with respect to an aircraft or vessel will not be considered as made by a transferee or distributee.

(f) *Election*—(1) *Time for making the election.* The election under this section must be made before the expiration of the period prescribed by section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election is to apply. The period for that first taxable year is determined without regard to the special periods prescribed by section 6511(d).

(2) *Manner of making the election.* An election under this section must be made by filing with the income tax return (or an amended return) for the first taxable year for which the election is to apply a statement, signed by the taxpayer, to the effect that the election under section 861(e) is being made. The statement must—

(i) Set forth sufficient facts to identify the aircraft or vessel which is the subject of the election,

(ii) State that the aircraft or vessel was manufactured or constructed in the United States,

(iii) State that the aircraft or vessel is section 38 property described in § 1.861-9(b) which was leased to a United States person (as defined in section 7701(a)(30) of the Code) pursuant to a lease entered into after August 15, 1971,

(iv) State that the electing taxpayer is the owner of the aircraft or vessel,

(v) State the lessee of the aircraft or vessel is not a member of a controlled group of corporations (as defined in section 1563) of which the taxpayer is a member,

(vi) Give the name and taxpayer identification number of the lessee of the aircraft or vessel, and

(vii) State that the aircraft or vessel is not subject to a sublease (other than a short-term sublease) to any person who is not a United States person.

(3) *Election by partnership.* Any election under this section with respect to an aircraft or vessel owned by a partnership shall be made by the partnership. Any partnership election is applicable to each partner's partnership interest in the aircraft or vessel. However, an election made by a partner before August 8, 1979 will be recognized where the partnership made no election and the election can no longer be revoked without the consent of the Commissioner under paragraph (g)(1) of this section.

(g) *Termination of election*—(1) *Revocation without consent.* A taxpayer may revoke an election within the time prescribed in paragraph (f)(1) of this section without the consent of the Commissioner. In such a case, the taxpayer must file an amended income tax return for any taxable year to which the election applied.

(2) *Revocation with consent.* Except as provided in paragraph (g) (1) or (3) of this section, an election made under this section is binding unless consent to revoke is obtained from the Commissioner. A request to revoke the election must be made in writing and addressed to the Assistant Commissioner of Internal Revenue (Technical), Attention: T:C:C:3, Washington, D.C. 20224. The request must include the name and address of the taxpayer and be signed by the taxpayer or his duly authorized representative. It must specify the taxable year or years for which the revocation is to be effective and must be filed at least 90 days prior to the time (not including extensions) prescribed by law for filing the income tax return for the first taxable year for which the revocation of the election is to be effective or by November 6, 1979 whichever is later. The request must specify the grounds which are considered to justify the revocation. The Commissioner may require such additional information as may be necessary in order to determine whether the proposed revocation will be permitted. Consent will generally not be given to revoke an election where the revocation would result in treating gross income with respect to the aircraft or vessel (including any gain from the sale, exchange, or other disposition of such aircraft or vessel) as income from sources without the United States where, during the period the election was in effect, there were losses from sources within the United States. A copy of the consent of the Commissioner to revoke must be attached to the taxpayer's income tax return (or amended return) for each taxable year affected by the revocation.

(3) *Automatic termination.* If an aircraft or vessel subject to an election under section 861(e) ceases to be section 38 property, ceases to be leased by its owner directly to a United States person, or is subleased (other than a short-term sublease) to a person who is not a United States person, within the period set forth in section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the election applied, then the election with respect to such aircraft or vessel will automatically terminate. If the election terminates, the taxpayer who made the election must file an amended tax return or claim for credit or refund, as the case may be, for any taxable year to which the election applied.

(4) *Factors not causing revocation or termination.* The fact that an aircraft or vessel ceases to be section 38 property, ceases to be leased by its owner directly to a United States person, or is leased or subleased for any period of time to a person who is not a United States person, after expiration of the period set forth in section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for the

first taxable year for which the election applied, will not cause a termination of the election made under this section with respect to the aircraft or vessel. For example, the electing taxpayer is not relieved from any of the consequences of making the election merely because the aircraft or vessel is subleased to a person who is not a United States person for a period in excess of that allowed for short-term subleases under paragraph (c) of this section after expiration of the later of 3 years from the time the return was filed for the first taxable year to which the election applied or 2 years from the time the tax was paid for that year where the period set forth in section 6511(a) has not been extended by agreement.

(5) *Effect of revocation or termination.* If an election is revoked or terminated under this paragraph (g), the taxpayer is required to recompute the tax for the appropriate taxable years without reference to section 861(e)(1).

[T.D. 7635, 44 FR 46457, Aug. 8, 1979]

§ 1.862-1 Income specifically from sources without the United States.

(a) *Gross income.* (1) The following items of gross income shall be treated as income from sources without the United States:

(i) Interest other than that specified in section 861(a)(1) and § 1.861-2 as being derived from sources within the United States;

(ii) Dividends other than those derived from sources within the United States as provided in section 861(a)(2) and § 1.861-3;

(iii) Compensation for labor or personal services performed without the United States;

(iv) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, without the United States, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property;

(v) Gains, profits, and income from the sale of real property located without the United States; and

(vi) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States.

(2) In applying subparagraph (1)(iv) of this paragraph for taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of § 1.871-11.

(3) For determining the time and place of sale of personal property for purposes of subparagraph (1)(vi) of this paragraph, see paragraph (c) of § 1.861-7.

(4) Income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within that possession.

(5) If interest is paid on an obligation of a nonresident of the United States by a resident of the United States acting in the resident's capacity as a guarantor of the obligation of the nonresident, the interest will be treated as income from sources without the United States.

(6) For rules treating certain interest as income from sources without the United States, see paragraph (b) of § 1.861-2.

(7) For the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see paragraph (b) of § 1.861-4.

(b) *Taxable income.* The taxable income from sources without the United States, in the case of the items of gross income specified in paragraph (a) of this section, shall be determined on the same basis as that used in § 1.861-8 for determining the taxable income from sources within the United States.

(c) *Income from certain property.* For provisions permitting a taxpayer to elect to treat amounts of gross income attributable to certain aircraft or vessels as income from sources within the United States which would otherwise be treated as income from sources without the United States under paragraph (a) of this section, see § 1.861-9.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7378, 40 FR 45434, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 7635, 44 FR 46459, Aug. 8, 1979]

§ 1.863-1 Allocation of gross income under section 863(a).

(a) *General.* Items of gross income other than those specified in section 861(a) (§§ 1.861-2 to 1.861-7, inclusive) and section 862(a) (§ 1.862-1) shall be allocated or apportioned to sources within or without the United States, as provided in section 863(a); however, see § 1.863-2 for alternative method of determining the taxable income from sources within the United States in the case of the items specified in paragraph (b) of § 1.863-2.

(b) *Natural resources.* (1) The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that, due to the peculiar conditions of production and sale in a specific case or for other reasons, not all of the gross income derived therefrom should be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided by section 863(b) and § 1.863-2.

(2) If the Commissioner determines that the application of the provisions of subparagraph (1) of this paragraph does not result in a proper allocation or apportionment of income, the Commissioner may make such other allocation or apportionment as will, in his opinion, more clearly reflect the proper source of the income to which such subparagraph applies. This subparagraph shall apply with respect to taxable years beginning after December 31, 1957.

(c) *Taxable income.* The taxable income from sources within or without the United States, in the case of the items of gross income allocated under section 863(a), shall be determined on the same basis as that used in § 1.861-8 for determining the taxable income from sources within the United States. See also paragraph (b) of § 1.862-1.

§ 1.863-2 Income derived partly from sources within and partly from sources without the United States.

(a) *General.* Section 863(b) provides an alternative method for determining the taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method the entire taxable income in the case of such income is first determined by deducting the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. Then, pursuant to processes or formulas of general apportionment prescribed by the Secretary or his delegate, a portion of such entire taxable income is determined as being attributable to sources within the United States. Thus, the income treated as derived partly from sources within and partly from sources without the United States may be allocated to sources within or without the United States pursuant to § 1.863-1 or apportioned to such sources in accordance with the method described in this section.

(b) *Applicable items.* The income to which this section applies (and which is treated as derived partly from sources within and partly from sources without the United States) shall consist of gains, profits, and income—

(1) From transportation or other services rendered partly within and partly without the United States;

(2) From the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in

whole or in part) by the taxpayer without and sold within the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States.

(c) *Cross reference.* For allocation or apportionment under § 1.863-1 or this section in the case of the principal items to which this section applies, see §§ 1.863-3, 1.863-4, and 1.863-5.

§ 1.863-3 Income from the sale of personal property derived partly from within and partly from without the United States.

(a) *General*—(1) *Classes of income.* Income from the sale of property to which paragraph (b) (2) and (3) of § 1.863-2 applies is divided into two classes for purposes of this section, namely, income which is treated as derived partly from sources within the United States and partly from sources within a foreign country, and income which is treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

(2) *Definition.* For purposes of this section, the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged. For determining the time and place of sale of personal property for purposes of this section, see paragraph (c) of § 1.861-7.

(b) *Income partly from sources within a foreign country*—(1) *General.* This paragraph relates to gains, profits, and income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States. Pursuant to section 863(b) such items shall be treated as derived partly from sources within the United States and partly from sources within a foreign country.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in this subparagraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861-8 shall be taken into account.

Example (1). Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

Example (2). (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale or personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly allocated and apportioned thereto in accordance with the rules set forth in § 1.861-8.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such taxable income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country.

(iii) The term "gross sales", as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(iv) The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis.

(v) Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

Example (3). Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed the taxable income derived from sources within the United States.

(c) *Income partly from sources within a possession of the United States*—(1) *General.* This paragraph relates to gains, profits, and income which, pursuant to section 863(b), are treated as derived partly from sources within the United States and partly from sources within a possession of the United States. The items so treated are described in subparagraphs (3) and (4) of this paragraph.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in subparagraphs (3) and (4) of this paragraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861-8 shall be taken into account.

(3) *Personal property produced and sold.* This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

Example (1). Same as example (1) under paragraph (b)(2) of this section.

Example (2). (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly allocated and apportioned thereto in accordance with the rules set forth in § 1.861-8.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such taxable income shall be apportioned in accordance with the total business of the taxpayer within the

United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) "The business of the taxpayer", as used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales.

Example (3). Same as example (3) under paragraph (b)(2) of this section.

(4) *Personal property purchased and sold.* This subparagraph relates to gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States.

Example (1). (i) The taxable income shall first be computed by deducting from such gross income the expenses, losses, or other deductions properly allocated or apportioned thereto in accordance with the rules set forth in § 1.861-8.

(ii) The amount of taxable income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such taxable income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as that term is used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Example (2). Same as example (3) under paragraph (b)(2) of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7456, 42 FR 1214, Jan. 6, 1977]

§ 1.863-4 Transportation service.

(a) *General.* A taxpayer carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services, such as the sale of money orders, shall be apportioned on the same basis as direct revenues from transportation services.

(c) *Allocation of costs or expenses.* In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States shall be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage; and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the internal revenue laws shall be taken into account.

(d) *Items not included as costs or expenses*—(1) *Taxes and interest.* Income, war profits, and excess profits taxes shall not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and, for such purpose, interest and other expenses for the use of borrowed capital shall not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. See paragraph (f)(2) of this section.

(2) *Other business activity and general expenses.* If a taxpayer subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f)(3) of this section.

(3) *Personal exemptions and special deductions.* The deductions for the personal exemptions, and the special deductions described in paragraph (c) of § 1.861-8, shall not be taken into account for purposes of paragraph (c) of this section.

(e) *Property used while within the United States*—(1) *General.* The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year.

(2) *Average property.* For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets.* Current assets shall be decreased by current liabilities and allcoated to services between the United States and foreign countries and to other services. The part allocated to services between the United

States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income*—(1) *General.* In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.* Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.* General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d)(2) of this section.

(4) *Personal exemptions.* The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861-8.

(5) *Special deductions.* The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861-8.

(g) *Allocation based on books of account.* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed by paragraphs (b) to (f), inclusive, of this section.

§ 1.863-5 Telegraph and cable services.

(a) *General.* A taxpayer carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by adding the gross revenues derived from messages originating in the United States and amounts collected abroad on collect messages originating in the United States and then deducting from such sum amounts paid or accrued for transmission of messages beyond the taxpayer's own circuit. Amounts received by the taxpayer in the United States with respect to collect messages originating without the United States shall be excluded from such gross income.

(c) *Taxable income.* In computing taxable income from sources within the United States, the following items shall be allowed as deductions from the gross income determined in accordance with paragraph (b) of this section:

(1) All expenses incurred in the United States (not including any general overhead expenses) incident to the carrying on of the business in the United States;

(2) All direct expenses incurred abroad in the transmission of messages originating in the United States (not including any general overhead expenses or maintenance, repairs, and depreciation of cables and not including any amount already deducted in computing gross income);

(3) Depreciation of property (other than cables) located in the United States and used in the trade or business therein; and,

(4) A proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in subparagraphs (1), (2), and (3) of this paragraph) and of maintenance, repairs, and depreciation of cables of the entire cable system of the enterprise, based on the ratio which the number of words originating in the United States bears to the total words transmitted by the enterprise.

(5) The deductions for the personal exemptions, and the special deductions allowed by sections 241, 922, and 941, but only to the extent provided by paragraphs (b) and (c) of § 1.861-8.

§ 1.863-6 Income from sources within a foreign country or possession of the United States.

The principles applied in §§ 1.861-1 to 1.863-5, inclusive, for determining the gross and the taxable income from sources within and without the United States shall generally be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States. This section shall not apply, however, to the extent it is determined by applying § 1.863-3 that a portion of the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country or possession of the United States. In the application of this section the name of the particular foreign country or possession of the United States shall be substituted for the term "United States", and the term "domestic" shall be construed to mean created or organized in such foreign country or possession. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243, 245, and 931 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country or possession of the United States shall not exceed the amount which, by applying any provision of §§ 1.861-1 to 1.863-5, inclusive, without reference to this section, is treated as income from sources without the United States.

[T.D. 7378, 40 FR 45435, Oct. 2, 1975]

§ 1.864-1 Meaning of sale, etc.

For purposes of §§ 1.861 through 1.864-7, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", and "aged".

[T.D. 6948, 33 FR 5090, Mar. 28, 1968]

§ 1.864-2 Trade or business within the United States.

(a) *In general.* As used in part I (section 861 and following) and part II (section 871 and following), subchapter N, chapter 1 of the Code, and chapter 3 (section 1441 and following) of the Code, and the regulations thereunder, the term "engaged in trade or business within the United States" does not include the activities described in paragraphs (c) and (d) of this section, but includes the performance of personal services within the United States at any time within the taxable year except to the extent otherwise provided in this section.

(b) *Performance of personal services for foreign employer*—(1) *Excepted services.* For purposes of paragraph (a) of this section, the term "engaged in trade or business within the United States" does not include the performance of personal services—

(i) For a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States at any time during the taxable year, or

(ii) For an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation, by a nonresident alien individual who is temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate gross amount of $3,000.

(2) *Rules of application.* (i) As a general rule, the term "day", as used in subparagraph (1) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(ii) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(iii) In applying subparagraph (1) of this paragraph it is immaterial whether the services performed by the nonresident alien individual are performed as an employee for his employer or under any form of contract with the person for whom the services are performed.

(iv) In determining for purposes of subparagraph (1) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of $3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in § 1.162-17 and paragraph (e)(4) of § 1.274-5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to personal services performed in the United States are not to be taken into account for purposes of subparagraph (1) of this paragraph.

(v) See section 7701(a)(5) and § 301.7701-5 of this chapter (Procedure and Administration Regulations) for the meaning of "foreign" when applied to a corporation or partnership.

(vi) As to the source of compensation for personal services, see §§ 1.861-4 and 1.862-1.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). During 1967, A, a nonresident alien individual, is employed by the London office of a domestic partnership. A, who uses the calendar year as his taxable year, is temporarily present in the United States during 1967 for 60 days performing personal service in the United States for the London office of the partnership and is paid by that office a total gross salary of $2,600 for such services. During 1967, A is not engaged in trade or business in the United States solely by reason of his performing such personal services for the London office of the domestic partnership.

Example (2). The facts are the same as in example (1), except that A's total gross salary for the services performed in the United States during 1967 amounts to $3,500, of which $2,625 is received in 1967 and $875 is received in 1968. During 1967, is engaged in trade or business in the United States by reason of his performance of personal services in the United States.

(c) *Trading in stocks or securities.* For purposes of paragraph (a) of this section—

(1) *In general.* The term "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in stocks or securities through a resident broker, commission agent, custodian, or other independent agent. This subparagraph shall apply to any taxpayer, including a broker or dealer in stocks or securities, except that it shall not apply if at any time during the taxable year the taxpayer has an

office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected. The volume of stock or security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States.

(2) *Trading for taxpayer's own account*—(i) *In general.* The term "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in stocks or securities for the taxpayer's own account, irrespective of whether such transactions are effected by or through—

(*a*) The taxpayer himself while present in the United States,

(*b*) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions, or

(*c*) A broker, commission agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is (*1*) dependent or independent, or (*2*) resident, nonresident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions. For purposes of this paragraph, the term "securities" means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing; and the effecting of transactions in stocks or securities includes buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading). The volume of stock of security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States. The application of this subdivision may be illustrated by the following example:

Example. A, a nonresident alien individual who is not a dealer in stocks or securities, authorizes B, an individual resident of the United States, as his agent to effect transactions in the United States in stocks and securities for the account of A. B is empowered with complete authority to trade in stocks and securities for the account of A and to use his own discretion as to when to buy or sell for A's account. This grant of discretionary authority from A to B is also communicated in writing by A to various domestic brokerage firms through which A ordinarily effects transactions in the United States in stocks or securities. Under the agency arrangement B has the authority to place orders with the brokers, and all confirmations are to be made by the brokers to B, subject to his approval. The brokers are authorized by A to make payments to B and to charge such payments to the account of A. In addition, B is authorized to obtain and advance the necessary funds, if any, to maintain credits with the brokerage firms. Pursuant to his authority B carries on extensive trading transactions in the United States during the taxable year through the various brokerage firms for the account of A. During the taxable year A makes several visits to the United States in order to discuss with B various aspects of his trading activities and to make necessary changes in his trading policy. A is not engaged in trade or business within the United States during the taxable year solely because of the effecting by B of transactions in the United States in stocks or securities during such year for the account of A.

(ii) *Partnerships.* A nonresident alien individual, foreign partnership, foreign estate, foreign trust, or foreign corporation shall not be considered to be engaged in trade or business within the United States solely because such person is a member of a partnership (whether domestic or foreign) which, pursuant to discretionary authority granted to such partnership by such person, effects transactions in the United States in stocks or securities for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects transactions in the United States in stocks or securities for the account of such partnership. This subdivision shall not apply, however, to any member of (*a*) a partnership which is a dealer in stocks or securities or (*b*) a partnership (other than a partnership in which, at any time during the last half of its taxable year, more than 50 percent of either the capital interest or the profits interest is owned, directly or indirectly, by five or fewer partners who are individuals) the principal business of which is trading in stocks or securities for its own account, if the principal office of such partnership is in the United States at any time during the taxable year. The principles of subdivision (iii) of this subparagraph for determining whether a foreign corporation has its principal office in the United States shall apply in determining under this subdivision whether a partnership has its principal office in the United States. See section 707(b)(3) and paragraph (b)(3) of § 1.707-1 for rules for determining the extent of the ownership by a partner of a capital interest or profits interest in a partnership. The application of this subdivision may be illustrated by the following examples:

Example (*1*). B, a nonresident alien individual, is a member of partnership X, the members of which are U.S. citizens, nonresident alien individuals, and foreign corporations. The principal business of partnership X is trading in stocks or securities for its own account. Pursuant to discretionary authority granted by B, partnership X effects transactions in the United States in stocks or securities for its own account. Partnership X is not a dealer in stocks or securities, and more than 50 percent of either the capital interest or the profits interest in partnership X is owned throughout its taxable year by five or fewer partners who are individuals. B is not engaged in trade or business within the United States solely by reason of such effecting of transactions in the United States in stocks or securities by partnership X for its own account.

Example (*2*). The facts are the same as in example (1), except that not more than 50 percent of either the capital interest or the profits interest in partnership X is owned throughout the taxable year by five or fewer partners who are individuals. However, partnership X does not maintain its principal office in the United States at any time during the taxable year. B is not engaged in trade or business within the United States solely by reason of the trading in stocks or securities by partnership X for its own account.

Example (*3*). The facts are the same as in example (1), except that, pursuant to discretionary authority granted by partnership X, domestic broker D effects transactions in the United States in stocks or securities for the account of partnership X. B is not engaged in trade or business in the United States solely by reason of such trading in stocks or securities for the account of partnership X.

(iii) *Dealers in stocks or securities and certain foreign corporations.* This subparagraph shall not apply to the effecting of transactions in the United States for the account of (*a*) a dealer in stocks or securities or (*b*) a foreign corporation (other than a corporation which is, or but for section 542(c)(7) or 543(b)(1)(C) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if the principal office of such corporation is in the United States at any time during the taxable year. Whether a foreign corporation's principal office is in the United States for this purpose is to be determined by comparing the activities (other than trading in stocks or securities) which the corporation conducts from its office or other fixed place of business located in the United States with the activities it conducts from its offices or other fixed places of business located outside the United States. For purposes of this subdivision, a foreign corporation is considered to have only one principal office, and an office of such corporation will not be considered to be its principal office merely because it is a statutory office of such corporation. For example, a foreign corporation which carries on most or all of its investment activities in the United States but maintains a general business office or offices outside the United States in which its management is located will not be considered as having its principal office in the United States if all or a substantial portion of the following functions is carried on at or from an office or offices located outside the United States:

(*1*) Communicating with its shareholders (including the furnishing of financial reports),

(*2*) Communicating with the general public, (*3*) Soliciting sales of its own stock,

(*4*) Accepting the subscriptions of new stockholders,

(*5*) Maintaining its principal corporate records and books of account,

(*6*) Auditing its books of account,

(*7*) Disbursing payments of dividends, legal fees, accounting fees, and officers' and directors' salaries,

(*8*) Publishing or furnishing the offering and redemption price of the shares of stock issued by it,

(*9*) Conducting meetings of its shareholders and board of directors, and

(*10*) Making redemptions of its own stock.

The application of this subdivision may be illustrated by the following examples:

Example (*1*). (a) Foreign corporation X (not a corporation which is, or but for section 542(c)(7) or 543(b)(1)(C) would be, a personal holding company) was organized to sell its shares to nonresident alien individuals and foreign corporations and to invest the proceeds from the sale of such shares in stocks or securities in the United States. Foreign corporation X is engaged primarily in the business of investing, reinvesting, and trading in stocks or securities for its own account.

(b) For a period of three years, foreign corporation X irrevocably authorizes domestic corporation Y to exercise its discretion in effecting transactions in the United States in stocks or securities for the account and risk of foreign corporation X. Foreign corporation X issues a prospectus in which it is stated that its funds will be invested pursuant to an investment advisory contract with domestic corporation Y and otherwise advertises its services. Shares of foreign corporation X are sold to nonresident aliens and foreign corporations who are customers of the United States brokerage firms unrelated to domestic corporation Y or foreign corporation X. The principal functions performed for foreign corporation X by domestic corporation Y are the rendering of investment advice and the effecting of transactions in the United States in stocks or securities for the account of foreign corporation X. Moreover, domestic corporation Y occasionally communicates with prospective foreign investors in foreign corporation X (through speaking engagements abroad by management of domestic corporation Y, and otherwise) for the purpose of explaining the investment techniques and policies used by domestic corporation Y in investing the funds of foreign corporation X. However, domestic corporation Y does not participate in the day-to-day conduct of other business activities of foreign corporation X.

(c) Foreign corporation X maintains a general business office or offices outside the United States in which its management is permanently located and from which it carries on, except to the extent noted heretofore, the functions enumerated in (*b*)(*1*) through (*10*) of this subdivision. The management of foreign corporation X at all times retains the independent power to cancel the investment advisory contract with domestic corporation Y subject to the contractual limitations contained therein and is in all other respects independent of the management of domestic corporation Y. The managing personnel of foreign corporation X communicate on a regular basis with domestic corporation Y, and periodically visit the offices of domestic corporation Y, in connection with the business activities of foreign corporation X.

(d) The principal office of foreign corporation X will not be considered to be in the United States; and, therefore, foreign corporation X is not engaged in trade or business within the United States solely by reason of its relationship with domestic corporation Y.

Example (*2*). The facts are the same as in example (1) except that, in lieu of having the investment advisory contract with domestic corporation Y, foreign corporation X has an office in the United States in which its employees perform the same functions as are performed by domestic corporation Y in example (1). Foreign corporation X is not engaged in trade or business within the United States during the taxable year solely because the employees located in its United States office effect transactions in the United States in stocks or securities for the account of that corporation.

(iv) *Definition of dealer in stocks or securities*—(*a*) *In general.* For purposes of this subparagraph, a dealer in stocks or securities is a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell, or hold, stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations, members of partnerships, or fiduciaries, who in their individual capacities buy and sell, or hold, stocks or securities for investment or speculation are not dealers in stocks or securities within the meaning of this subparagraph solely by reason of that activity. In determining under this subdivision whether a person is a dealer in stocks or securities such person's transactions in stocks or securities effected both in and outside the United States shall be taken into account.

(*b*) *Underwriting syndicates and dealers trading for others.* A foreign person who otherwise may be considered a dealer in stocks or securities under (a) of this subdivision shall not be considered a dealer in stocks or securities for purposes of this subparagraph—

(*1*) Solely because he acts as an underwriter, or as a selling group member, for the purpose of making a distribution of stocks or securities of a domestic issuer to foreign purchasers of such stocks or securities, irrespective of whether other members of the selling group distribute the stocks or securities of the domestic issuer to domestic purchasers, or

(*2*) Solely because of transactions effected in the United States in stocks or securities pursuant to his grant of discretionary authority to make decisions in effecting those transactions, if he can demonstrate to the satisfaction of the Commissioner that the broker, commission agent, custodian, or other agent through whom the transactions were effected acted pursuant to his written representation that the funds in respect of which such discretion was granted were the funds of a customer who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)(*b*) of this subparagraph, or a foreign corporation described in subdivision (iii)(*b*) of this subparagraph.

For purposes of this (*b*), a foreign person includes a nonresident alien individual, a foreign corporation, or a partnership any member of which is a nonresident alien individual or a foreign corporation. This (*b*) shall apply only if the foreign person at no time during the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in stocks or securities are effected.

(*c*) *Illustrations.* The application of this subdivision may be illustrated by the following examples:

Example (*1*). Foreign corporation X is a member of an underwriting syndicate organized to distribute stock issued by domestic corporation Y. Foreign corporation X distributes the stock of domestic corporation Y to foreign purchasers only. Domestic corporation M is syndicate manager of the underwriting syndicate and, pursuant to the terms of the underwriting agreement, reserves the right to sell certain quantities of the underwritten stock on behalf of all the members of the syndicate so as to engage in stabilizing transactions and to take certain other actions which may result in the realization of profit by all members of the underwriting syndicate. Foreign corporation X is not engaged in trade or business within the United States solely by reason of its participation as a member of such underwriting syndicate for the purpose of distributing the stock of domestic corporation Y to foreign purchasers or by reason of the exercise by M corporation of its discretionary authority as manager of such syndicate.

Example (*2*). Foreign corporation Y, a calendar year taxpayer, is a bank which trades in stocks or securities both for its own account and for the account of others. During 1967 foreign corporation Y authorizes domestic corporation M, a broker, to exercise its discretion in effecting transactions in the United States in stocks or securities for the account of B, a nonresident alien individual who has a trading account with foreign corporation Y. Foreign corporation Y furnishes a written representation to domestic corporation M to the effect that the funds in respect of which foreign corporation Y has authorized domestic corporation M to use its discretion in trading in the United States in stocks or securities are not funds in respect of which foreign corporation Y is trading for its own account but are the funds of one of its customers who is neither a dealer in stocks or securities, a partnership described in subdivision (ii)(*b*) of this subparagraph, or a foreign corporation described in subdivision (iii)(*b*) of this subparagraph. Pursuant to the discretionary authority so granted, domestic corporation M effects transactions in the United States during 1967 in stocks or securities for the account of the customer of foreign corporation Y. At no time during 1967 does foreign corporation Y have an office or other fixed place of business in the United States through which, or by the direction of which, such transactions in stocks or securities are effected by domestic corporation M. During 1967 foreign corporation Y is not engaged in trade or business within the United States solely by reason of such trading in stocks or securities during such year by domestic corporation M for the account of the customer of foreign corporation Y. Copies of the written representations furnished to domestic corporation M should be retained by foreign corporation Y for inspection by the Commissioner, if inspection is requested.

(d) *Trading in commodities.* For purposes of paragraph (a) of this section—

(1) *In general.* The term "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in commodities (including hedging transactions) through a resident broker, commission agent, custodian, or other independent agent if (i) the commodities are of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market, (ii) the transaction is of a kind customarily consummated at such place, and (iii) the taxpayer at no time during the taxable year has an office or other fixed place of business in the United States through which, or by the direction of which, the transactions in commodities are effected. The volume of commodity transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business in the United States.

(2) *Trading for taxpayer's own account*—(i) *In general.* The term "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in commodities (including hedging transactions) for the taxpayer's own account if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place. This rule shall apply irrespective of whether such transactions are effected by or through—

(*a*) The taxpayer himself while present in the United States,

(*b*) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions, or

(*c*) A broker, commission, agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is (*1*) dependent or independent, or (*2*) resident, nonresident, or present, in the United States,

and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions. The volume of commodity transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in trade or business within the United States. This subparagraph shall not apply to the effecting of transactions in the United States for the account of a dealer in commodities.

(ii) *Partnerships.* A nonresident alien individual, foreign partnership, foreign estate, foreign trust, or foreign corporation shall not be considered to be engaged in trade or business within the United States solely because such person is a member of a partnership (whether domestic or foreign) which, pursuant to discretionary authority granted to such partnership by such person, effects transactions in the United States in commodities for the partnership's account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects transactions in the United States in commodities for the account of such partnership. This subdivision shall not apply to any member of a partnership which is a dealer in commodities.

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. Foreign corporation X, a calendar year taxpayer, is engaged as a merchant in the business of purchasing grain in South America and selling such cash grain outside the United States under long-term contracts for delivery in foreign countries. Foreign corporation X consummates a sale of 100,000 bushels of cash grain in February 1967 for July delivery to Sweden. Because foreign corporation X does not actually own such grain at the time of the sales transaction, such corporation buys as a hedge a July "futures contract" for delivery of 100,000 bushels of grain, in order to protect itself from loss by reason of a possible rise in the price of grain between February and

July. The "futures contract" is ordered through domestic corporation Y, a futures commission merchant registered under the Commodity Exchange Act. Foreign corporation X is not engaged in trade or business within the United States during 1967 solely by reason of its effecting of such futures contract for its own account through domestic corporation Y.

(3) *Definition of commodity.* For purposes of section 864(b)(2)(B) and this paragraph the term "commodities" does not include goods or merchandise in the ordinary channels of commerce.

(e) *Other rules.* The fact that a person is not determined by reason of this section to be not engaged in trade or business with the United States is not to be considered a determination that such person is engaged in trade or business within the United States. Whether or not such person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case. For other rules relating to the determination of whether a taxpayer is engaged in trade or business in the United States see section 875 and the regulations thereunder.

(f) *Effective date.* The provisions of this section shall apply only in the case of taxable years beginning after December 31, 1966.

[T.D. 6948, 33 FR 5090, Mar. 28, 1968, as amended by T.D. 7378, 40 FR 45435, Oct. 2, 1975]

1.864-3 Rules for determining income effectively connected with U.S. business of nonresident aliens or foreign corporations.

(a) *In general.* For purposes of the Internal Revenue Code, in the case of a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at any time during the taxable year, the rules set forth in §§ 1.864-4 through 1.864-7 and this section shall apply in determining whether income, gain, or loss shall be treated as effectively connected for a taxable year beginning after December 31, 1966, with the conduct of a trade or business in the United States. Except as provided in sections 871 (c) and (d) and 882 (d) and (e), and the regulations thereunder, in the case of a nonresident alien individual or a foreign corporation that is at no time during the taxable year engaged in a trade or business in the United States, no income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. The general rule prescribed by the preceding sentence shall apply even though the income, gain, or loss would have been treated as effectively connected with the conduct of a trade or business in the United States if such income or gain had been received or accrued, or such loss had been sustained, in an earlier taxable year when the taxpayer was engaged in a trade or business in the United States. In applying §§ 1.864-4 through 1.864-7 and this section, the determination whether an item of income, gain, or loss is effectively connected with the conduct of a trade or business in the United States shall not be controlled by any administrative, judicial, or other interpretation made under the laws of any foreign country.

(b) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). During 1967 foreign corporation N, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling household equipment on the installment plan. During 1967 N is engaged in business in the United States by reason of the sales activities it carries on in the United States for the purpose of selling therein some of the equipment which it has purchased. During 1967 N receives installment payments of $800,000 on sales it makes that year in the United States, and the income from sources within the United States for 1967 attributable to such payments is $200,000. By reason of section 864(c)(3) and paragraph (b) of § 1.864-4 this income of $200,000 is effectively connected for 1967 with the conduct of a trade or business in the United States by N. In December of 1967, N discontinues its efforts to make any further sales of household equipment in the United States, and at no time during 1968 is N engaged in a trade or business in the United States. During 1968 N receives installment payments of $500,000 on the sales it made in the United States during 1967, and the income from sources within the United States for 1968 attributable to such payments is $125,000. By reason of section 864(c)(1)(B) and this section, this income of $125,000 is not effectively connected for 1968 with the conduct of a trade or business in the United States by N, even though such amount, if it had been received by N during 1967, would have been effectively connected for 1967 with the conduct of a trade or business in the United States by that corporation.

Example (2). R, a foreign holding company, owns all of the voting stock in five corporations, two of which are domestic corporations. All of the subsidiary corporations are engaged in the active conduct of a trade or business. R has an office in the United States where its chief executive officer, who is also the chief executive officer of one of the domestic corporations, spends a substantial portion of the taxable year supervising R's investment in its operating subsidiaries and performing his function as chief executive officer of the domestic operating subsidiary. R is not considered to be engaged in a trade or business in the United States during the taxable year by reason of the activities carried on in the United States by its chief executive officer in the supervision of its investment in its operating subsidiary corporations. Accordingly, the dividends from sources within the United States received by R during the taxable year from its domestic subsidiary corporations are not effectively connected for that year with the conduct of a trade or business in the United States by R.

Example (3). During the months of June through December 1971, B, a nonresident alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is employed in the United States by domestic corporation M for a salary of $2,000 per month, payable semimonthly. During 1971, B receives from M salary payments totaling $13,000, all of which income by reason of section 864(c)(2) and paragraph (c)(6)(ii) of § 1.864-4, is effectively connected for 1971 with the conduct of a trade or business in the United States by B. On December 31, 1971, B terminates his employment with M and departs from the United States. At no time during 1972 is B engaged in a trade or business in the United States. In January of 1972, B receives from M salary of $1,000 for the last half of December 1971, and a bonus of $1,000 in consideration of the services B performed in the United States during 1971 for that corporation. By reason of section 864(c)(1)(B) and this section, the $2,000 received by B during 1972 from sources within the United States is not effectively connected for that year with the conduct of a trade or business in the United States, even though such amount, if it had been received by B during 1971, would have been effectively connected for 1971 with the conduct of a trade or business in the United States by B.

[T.D. 7216, 37 FR 23424, Nov. 3, 1972]

§ 1.864-4 U.S. source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources within the United States. If the income, gain, or loss of such person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

(b) *Income other than fixed or determinable income and capital gains.* All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year. The application of this paragraph may be illustrated by the following examples:

Example (1). M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is engaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.

Example (2). The facts are the same as in example (1) except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufactures.

Example (3). Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

(c) *Fixed or determinable income and capital gains*—(1) *Principal factors to be taken into account*—(i) *In general.* In determining for purposes of paragraph (a) of this section whether any income for the taxable year from sources within the United States which is described in section 871(a)(1) or 881(a), relating to fixed or determinable annual or periodical gains, profits, and income and certain other gains, or whether gain or loss from sources within the United States for the taxable year from the sale or exchange of capital assets, is effectively connected for the taxable year with the conduct of a trade or business in the United States, the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

(ii) *Special rule relating to interest on certain deposits.* For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before Jan. 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and § 1.864-5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated as interest from sources without the United States which is not subject to the application of § 1.864-5.

(2) *Application of the asset-use test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the asset-use test ordinarily shall apply in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of primary significance where, for example, interest or dividend income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Cases where applicable.* Ordinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

(*a*) Held for the principal purpose of promoting the present conduct of the trade or business in the United States, as, for example, in the case of stock acquired and held to assure a constant source of supply for the trade or business, or

(*b*) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business, or

(*c*) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under subdivision (iii) of this subparagraph.

(iii) *Direct relationship between holding of asset and trade or business*—(*a*) *In general.* In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or buisness. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for (*1*) future diversification into a new trade or business, (*2*) expansion of trade or business activities conducted outside of the United States, (*3*) future plant replacement, or (*4*) future business contingencies.

(*b*) Presumption of direct relationship. Generally, an asset will be treated as held in a direct relationship to the trade or business if (*1*) the asset was acquired with funds generated by that trade or business, (*2*) the income from the asset is retained or reinvested in that trade or business, and (*3*) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

(iv) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities, M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

Example (2). R, a foreign corporation engaged in the manufacture of goods, maintains a factory at its branch in the United States and by reason of its activities therein is engaged in business in the United States during the taxable year 1968. R engages a stock brokerage firm in the United States to manage its securities which were purchased with funds from R's general surplus reserves. The brokerage firm is engaged by the U.S. branch and is instructed to deposit all income and gains derived from the securities in the New York bank account of the U.S. branch. The funds invested in these securities are not necessary to provide for the present needs of the U.S. branch. Accordingly, the securities are not held in a direct relationship to the business conducted in the United States by R, and all such income and gains for 1968 from sources within the United States are not effectively connected for that year with the conduct of the business in the United States.

Example (3). S, a foreign corporation which uses the calendar year as the taxable year, is engaged in the manufacture of goods in a foreign country. S maintains a branch in the United States and by reason of the activities of that branch is engaged in business in the United States during 1968. S invests excess cash, which is generated by the U.S. branch but not currently needed in the business of the branch, in securities issued by domestic corporations. The securities are held in the name of S in a brokerage office in the United States, which receives and remits all income from the securities to S's home office abroad. The officers of the U.S. branch have authority to manage the securities held in the brokerage account of S. Any dividends and interest on the securities for 1968, and any gain or loss for that year resulting from the sale or exchange of the securities, are not effectively connected for 1968 with the conduct of the business in the United States by S, because the securities are not held to meet the present needs of that business and thus are not held in a direct relationship to that business.

Example (4). F, a foreign corporation which uses the calendar year as the taxable year, is engaged in business in the United States during 1968 through its manufacturing branch in the United States. The branch holds on its books stock in domestic corporation D, a wholly owned subsidiary of F. There is no relationship between the business of D and the business of F's branch in the United States, and the officers of D report to the home office of F and not to its U.S. branch. Dividends paid on the stock in D are paid to F's branch in the United States and are mingled with its general funds, but the U.S. branch has no present need in its business operations for the cash so received. Since the stock in D is not held in a direct relationship to the business conducted in the United States by F, any dividends received by F during 1968 on such stock are not effectively connected for that year with the conduct of that business.

Example (5). Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1968. The U.S. branch establishes in 1968 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1968, the branch office derives from sources within the United States dividends on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the dividends are retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under subdivision (iii)(*b*) of this subparagraph to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1968 are not effectively connected for that year with the conduct of a trade or business in the United States by M.

(3) *Application of the business-activities test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the business-activities test shall ordinarily apply in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where (*a*) dividends or interest are derived by a dealer in stocks or securities, (*b*) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (*c*) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (*d*) service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of § 1.864-2 and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, and losses.

Example (2). N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

(4) *Method of accounting as a factor.* In applying the asset-use test or the business-activities test described in subparagraph (1) of this paragraph, due regard shall be given to whether or not the asset, or the income, gain, or loss, is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain, or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be

given to whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.

(5) *Special rules relating to banking, financing, or similar business activity*—(i) *Definition of banking, financing, or similar business.* A nonresident alien individual or a foreign corporation shall be considered for purposes of this section and paragraph (b)(2) of § 1.864-5 to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States:

(*a*) Receiving deposits of funds from the public,

(*b*) Making personal, mortgage, industrial, or other loans to the public,

(*c*) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(*d*) Issuing letters of credit to the public and negotiating drafts drawn thereunder,

(*e*) Providing trust services for the public, or

(*f*) Financing foreign exchange transactions for the public.

Although the fact that the taxpayer is subjected to the banking and credit laws of a foreign country shall be taken into account in determining whether he is engaged in the active conduct of a banking, financing, or similar business, the character of the business actually carried on during the taxable year in the United States shall determine whether the taxpayer is actively conducting a banking, financing, or similar business in the United States. A foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of section 954(d)(3) if such foreign corporation were a controlled foreign corporation shall not be considered to be engaged in the active conduct of a banking, financing, or similar business in the United States.

(ii) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business.* Notwithstanding the rules in subparagraphs (2) and (3) of this paragraph with respect to the asset-use test and the business-activities test, any dividends or interest from stocks or securities, or any gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources within the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States shall be treated as effectively connected for such year with the conduct of that business only if the stocks or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on and—

(*a*) Were acquired—

(*1*) As a result of, or in the course of making loans to the public,

(*2*) In the course of distributing such stocks or securities to the public, or

(*3*) For the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States, or

(*b*) Consist of securities (as defined in subdivision (v) of this subparagraph) which are—

(*1*) Payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition,

(*2*) Issued by the United States, or any agency or instrumentality thereof, or

(*3*) Not described in (*a*) or in (*1*) or (*2*) of this (*b*).

However, the amount of interest from securities described in (*b*)(*3*) of this subdivision (ii) which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire interest for the taxable year from sources within the United States from such securities) determined by multiplying the entire interest for the taxable year from sources within the United States from such securities by a fraction the numerator of which is 10 percent and the denominator of which is the same percentage, determined on the basis of a monthly average for the taxable year, as the book value of the total of such securities held by the U.S. office through which such business is carried on bears to the book value of the total assets of such office. The amount of gain or loss, if any, for the taxable year from the sale or exchange of such securities which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities) determined by multiplying the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities by the fraction described in the immediately preceding sentence. The percentage of the denominator of the limiting fraction for such purposes shall be the percentage obtained by separately adding the book value of such securities and such total assets held at the close of each month in the taxable year, dividing each such sum by 12, and then dividing the amount of securities so obtained by the amount of assets so obtained. This subdivision does not apply to dividends from stock owned by a foreign corporation in a domestic corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by such foreign corporation and which is engaged in the active conduct of a banking business in the United States. The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation M, created under the laws of foreign country Y, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. During the taxable year M derives from sources within the United States through the activities carried on through B, $7,500,000 interest from securities described in subdivision *(b)(3)* of this subdivision (ii) and $7,500,000 gain from the sale or exchange of such securities. The monthly average, determined as of the last day of each month in the taxable year, of such securities held by B divided by the monthly average, as so determined, of the total assets held by B equals 15 percent. Under this subdivision, the amount of interest income from such securities that shall be treated as effectively connected for the taxable year with the active conduct by M of a banking business in the United States is $5 million ($7,500,000 interest × 10%/15%), and the amount of gain from the sale or exchange of such securities that shall be treated as effectively connected for such year with the active conduct of such business is $5 million ($7,500,000 gain × 10%/15%).

(iii) *Stocks or securities attributable to U.S. office—(a) In general.* For purposes of subdivision (ii) of this subparagraph, a stock or security shall be deemed to be attributable to a U.S. office only if—

(1) Such office actively participated in soliciting, negotiating, or performing other activities required to arrange, the acquisition of such stock or security, and

(2) Such stock or security is or was held in the United States by or for such office and recorded on its books or records as having been purchased or acquired by such office or for its account.

(b) Exceptions. A stock or security shall not be deemed to be attributable to a U.S. office merely because such office conducts one or more of the following activities:

(1) Collects or accounts for the dividends, interest, gain, or loss from such stock or security,

(2) Exercises general supervision over the activities of the persons directly responsible for carrying on the activities described in *(a)(1)* of this subdivision,

(*3*) Performs merely clerical functions incident to the acquisition of such stock or security, or

(*4*) Exercises final approval over the execution of the acquisition of such stock or security.

(iv) *Acquisitions in course of making loans to the public.* For purposes of subdivision (ii) of this subparagraph—

(*a*) A stock or security shall be considered to have been acquired in the course of making a loan to the public where, for example, such stock or security was acquired as additional consideration for the making of the loan,

(*b*) A stock or security shall be considered to have been acquired as a result of making a loan to the public if, for example, such stock or security was acquired by foreclosure upon a bona fide default of the loan and is held as an ordinary and necessary incident to the active conduct of the banking, financing, or similar business in the United States, and

(*c*) A stock or security acquired on a stock exchange or organized over-the-counter market shall be considered not to have been acquired as a result of, or in the course of, making loans to the public.

(v) *Security defined.* For purposes of this subparagraph, a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(vi) *Limitations on application of subparagraph—(a) Other business activity.* This subparagraph provides rules for determining when certain income from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources within the United States which by reason of the application of subdivision (ii) of this subparagraph is not effectively connected with the active conduct by a nonresident alien individual or a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under subparagraph (2) or (3) of this paragraph with the conduct by such taxpayer of another trade or business in the United States, such as, for example, the business of selling or manufacturing goods or merchandise or of trading in stocks or securities for the taxpayer's own account.

(*b*) *Other income.* For rules relating to income, gain, or loss from sources within the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in subdivision (ii) of this subparagraph) derived in the active conduct of a banking, financing, or similar business in the United States, see subparagraphs (2) and (3) of this paragraph and paragraph (b) of this section.

(vii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). Foreign corporation F, which is created under the laws of foreign country X and engaged in the active conduct of the banking business in country X and a number of other foreign countries, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. In the course of its banking business in foreign countries, F receives at its branches located in country X and other foreign countries substantial deposits in U.S. dollars which are transferred to the accounts of B in the United States. During the taxable year, B actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed from the U.S. dollar deposits transferred to B by F. In addition, B actively participates in purchasing on the New York Stock Exchange and over-the-counter markets long-term bonds and notes issued by the U.S. Government, U.S. Treasury bills, and long-term interest-bearing bonds issued by domestic corporations and having a maturity date of less than 1 year from the date of acquisition, all of which are purchased from the deposits transferred to B by F. All of the securities so acquired are held by B and recorded on its books in the United States. Pursuant to subdivision (ii) of this subparagraph, the interest received by F during the taxable year on these loans, bonds, notes, and bills is effectively connected for such year with the active conduct by F of a banking business in the United States.

Example (2). The facts are the same as in example (1) except that B also actively participates in using part of the U.S. dollar deposits, which are transferred to it by F, to purchase on the New York Stock Exchange shares of common stock issued by various domestic corporations. All of the shares so purchased are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. None of the shares so purchased were acquired for the purpose of meeting reserve or other similar requirements. During the taxable year some of the shares are sold by B on the stock exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example (3). The facts are the same as in example (1) except that B also uses part of the U.S. dollar deposits, which are transferred to it by F, to make a loan to domestic corporation M. As part of the consideration for the loan, M gives to B a number of shares of common stock issued by M. All of these shares of stock are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. During the taxable year one-half of these shares of stock is sold by B on the New York Stock Exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are effectively connected for such year with the active conduct by F of a banking business in the United States.

Example (4). The facts are the same as in example (1) except that during the taxable year the home office of F in country X actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed by the U.S. dollar deposits received at the home office and are recorded on the books of the home office. B does not participate in negotiating these loans. Pursuant to subdivision (ii) of this subparagraph the interest received by F during the taxable year on these loans made by the home office in country X is not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

(6) *Income related to personal services of an individual*—(i) *Income, gain, or loss from assets.* Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale or exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business of performing the personal services. This direct economic relationship exists, for example, where the individual purchases stock in a domestic corporation to assure the opportunity of performing personal services in the United States for that corporation.

(ii) *Wages, salaries, and pensions.* Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of § 1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

[T.D. 7216, 37 FR 23425, Nov. 3, 1972, as amended by T.D. 7332, 39 FR 44232, Dec. 23, 1974]

§ 1.864-5 Foreign source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United

States at some time during the taxable year, but not necessarily at the time the income, gain, or loss is realized, an office or other fixed place of business, as defined in § 1.864-7, to which such income, gain, or loss is attributable in accordance with § 1.864-6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effecively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a nonresident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under § 1.864-4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(b) *Income other than income attributable to U.S. life insurance business.* Income, gain, or loss from sources without the United States other than income described in paragraph (c) of this section shall be taken into account pursuant to paragraph (a) of this section in applying §§ 1.864-6 and 1.864-7 only if it consists of—

(1) *Rents, royalties, or gains on sales of intangible property.* (i) Rents or royalties for the use of, or for the privilege of using, intangible personal property located outside the United States or from any interest in such property, including rents or royalties for the use, or for the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such rents or royalties are derived in the active conduct of the trade or business in the United States.

(ii) Gains or losses on the sale or exchange of intangible personal property located outside the United States or from any interest in such property, including gains or losses on the sale or exchange of the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such gains or losses are derived in the active conduct of the trade or business in the United States.

(iii) Whether or not such an item of income, gain, or loss is derived in the active conduct of a trade or business in the United States shall be determined from the facts and circumstances of each case. The frequency with which a nonresident alien individual or a foreign corporation enters into transactions of the type from which the income, gain, or loss is derived shall not of itself determine that the income, gain, or loss is derived in the active conduct of a trade or business.

(iv) This subparagraph shall not apply to rents or royalties for the use of, or for the privilege of using, real property or tangible personal property, or to gain or loss from the sale or exchange of such property.

(2) *Dividends or interest, or gains or loss from sales of stocks or securities*—(i) *In general.* Dividends or interests from any transaction, or gains or losses on the sale or exchange of stocks or securities, realized by (*a*) a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or (*b*) a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account. Whether the taxpayer is engaged in the active conduct of a banking, financing, or similar business in the United States for purposes of this subparagraph shall be determined in accordance with the principles of paragraph (c)(5)(i) of § 1.864-4.

(ii) *Incidental investment activity.* This subparagraph shall not apply to income, gain, or loss realized by a nonresident alien individual or foreign corporation on stocks or securities held, sold, or exchanged in connection with incidental investment activities carried on by that person. Thus, a foreign corporation which is primarily a holding company owning significant percentages of the stocks or securities issued by other corporations shall not be treated under this subparagraph as a corporation the principal business of which is trading in stocks or securities for its own account, solely because it engages in sporadic purchases or sales of stocks or securities to adjust its portfolio. The application of this subdivision may be illustrated by the following example:

Example. F, a foreign corporation, owns voting stock in foreign corporations M, N, and P, its holdings in such corporations constituting 15, 20, and 100 percent, respectively, of all classes of their outstanding voting stock. Each of such stock holdings by F represents approximately 20 percent of its total assets. The remaining 40 percent of F's assets consist of other investments, 20 percent being invested in securities issued by foreign governments and in stocks and bonds issued by other corporations in which F does not own a significant percentage of their outstanding voting stock, and 20 percent being invested in bonds issued by N. None of the assets of F are held primarily for sale; but if the officers of that corporation were to decide that other investments would be preferable to its holding of such assets, F would sell the stocks and securities and reinvest the proceeds therefrom in other holdings. Any income, gain, or loss which F may derive from this investment activity is not considered to be realized by a foreign corporation described in subdivision (i) of this subparagraph.

(3) *Sale of goods or merchandise through U.S. office.* (i) Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other fixed place of business which the nonresident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

(ii) This subparagraph shall not apply to income, gain, or loss resulting from a sales contract entered into on or before February 24, 1966. See section 102(e)(1) of the Foreign Investors Tax Act of 1966 (80 Stat. 1547). Thus, for example, the sales office in the United States of a foreign corporation enters into negotiations for the sale of 500,000 industrial bearings which the corporation produces in a foreign country for consumption in the Western Hemisphere. These negotiations culminate in a binding agreement entered into on January 1, 1966. By its terms delivery under the contract is to be made over a period of 3 years beginning in March of 1966. Payment is due upon delivery. The income from sources without the United States resulting from this sale negotiated by the U.S. sales office of the foreign corporation shall not be taken into account under this subparagraph for any taxable year.

(iii) This subparagraph shall not apply to gains or losses on the sale or exchange of intangible personal property to which subparagraph (1) of this paragraph applies or of stocks or securities to which subparagraph (2) of this paragraph applies.

(c) *Income attributable to U.S. life insurance business.* (1) All of the income for the taxable year of a foreign corporation described in subparagraph (2) of this paragraph from sources without the United States, which is attributable to its U.S. life insurance business, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. Thus, in determining its life insurance company taxable income from its U.S. business for purposes of section 802, the foreign corporation shall include all of its items of income from sources without the United States which would appropriately be taken into account in determining the life insurance company taxable income of a domestic corporation. The income to which this subparagraph applies shall be taken into account for purposes of paragraph (a) of this section without reference to §§ 1.864-6 and 1.864-7.

(2) A foreign corporation to which subparagraph (1) of this paragraph applies is a foreign corporation carrying on an insurance business in the United States during the taxable year which—

(i) Without taking into account its income not effectively connected for that year with the conduct of any trade or business in the United States, would qualify as a life insurance company under part I (section 801 and following) of subchapter L, chapter 1 of the Code, if it were a domestic corporation, and

(ii) By reason of section 842 is taxable under that part on its income which is effectively connected for that year with its conduct of any trade or business in the United States.

(d) *Excluded foreign source income.* Notwithstanding paragraphs (b) and (c) of this section, no income from sources without the United States shall be treated as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation if the income consists of—

(1) *Dividends, interest, or royalties paid by a related foreign corporation.* Dividends, interest, or royalties paid by a foreign corporation in which the nonresident alien individual or the foreign corporation described in paragraph (a) of this section owns, within the meaning of section 958(a), or is considered as owning, by applying the ownership rules of section 958(b), at the time such items are paid more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(2) *Subpart F income of a controlled foreign corporation.* Any income of the foreign corporation described in paragraph (a) of this section which is Subpart F income for the taxable year, as determined under section 952(a), even though part of the income is attributable to amounts which, if distributed by the foreign corporation, would be distributed with respect to its stock which is owned by shareholders who are not U.S. shareholders within the meaning of section 951(b). This subparagraph shall not apply to any income of the foreign corporation which is excluded in determining its subpart F income for the taxable year for purposes of section 952(a). Thus, for example, this subparagraph shall not apply to—

(i) Any dividends, interest, or gains from qualified investments in less developed countries which are excluded under section 954(b)(1),

(ii) Foreign base company income amounting to less than 30 percent of gross income which by reason of section 954(b)(3)(A) does not become subpart F income for the taxable year,

(iii) Any income excluded from foreign base company income under section 954(b)(4), relating to exception for foreign corporations not availed of to reduce taxes,

(iv) Any income derived in the active conduct of a trade or business which is excluded under section 954(c)(3), or

(v) Any income received from related persons which is excluded under section 954(c)(4).

This subparagraph shall apply to the foreign corporation's entire subpart F income for the taxable year determined under section 952(a), even though no amount is included in the gross income of a U.S. shareholder under section 951(a) with respect to that subpart F income because of the minimum distribution provisions of section 963(a) or because of the reduction under section 970(a) with respect to an export trade corporation. This subparagraph shall apply only to a foreign corporation which is a controlled foreign corporation within the meaning of section 957 and the regulations thereunder. The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation M, incorporated under the laws of foreign country X, is engaged in the business of purchasing and selling merchandise manufactured in foreign country Y by an unrelated person. M negotiates sales, through its sales office in the United States, of its merchandise for use outside of country X. These sales are made outside the United States, and the merchandise is sold for use outside the United States. No office maintained by M outside the United States participates materially in the sales made through its U.S. sales office. These activities constitute the only activities of M. During the taxable year M derives $100,000 income from these sales made through its U.S. sales office, and all of such income is foreign base company sales income by reason of section 954(d)(2) and paragraph (b) of § 1.954-3. The entire $100,000 is also subpart F income, determined under section 952(a). In addition, all of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Through its entire taxable year 60 percent of the one class of stock of M is owned within the meaning of section 958(a) by U.S. shareholders, as defined in section 951(b), and 40 percent of its one class of stock is owned within the meaning of section 958(a) by persons who are not U.S. shareholders, as defined in section 951(b). Although only $60,000 of the subpart F income of M for the taxable year is includible in the income of the U.S. shareholders under section 951(a), the entire subpart F income of $100,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

Example (2). The facts are the same as in example (1) except that the foreign base company sales income amounts to $150,000 determined in accordance with paragraph (d)(3)(i) of § 1.954-1, and that M also has gross income from sources without the United States of $50,000 from sales, through its sales office in the United States, of merchandise for use in country X. These sales are made outside the United States. All of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Since the foreign base company income of $150,000 amounts to 75 percent of the entire gross income of $200,000, determined as provided in paragraph (d)(3)(ii) of § 1.954-1, the entire $200,000 constitutes foreign base company income under section 954(b)(3)(B). Assuming that M has no amounts to be taken into account under paragraphs (1), (2), (4), and (5) of section 954(b), the $200,000 is also subpart F income, determined under section 952(a). This subpart F income of $200,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

(3) *Interest on certain deposits.* Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) and paragraph (c) of § 1.864-4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

[T.D. 7216, 37 FR 23429, Nov. 3, 1972]

§ 1.864–6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.

(a) *In general.* Income, gain, or loss from sources without the United States which is specified in paragraph (b) of § 1.864-5 and received by a nonresident alien individual or a foreign corporation engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States only if the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in § 1.864-7, which the taxpayer has in the United States at some time during the taxable year.

(b) *Material factor test*—(1) *In general.* For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of the income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

(2) *Application of material factor test to specific classes of income.* For purposes of paragraph (a) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation, engaged in a trade or business in the United States at some time during the taxable year, had in the United States, shall be considered a material factor in the realization of income, gain, or loss consisting of—

(i) *Rents, royalties, or gains on sales of intangible property.* Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of § 1.864-5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (*a*) Develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged, (*b*) collects or accounts for the rents, royalties, gains, or losses, (*c*) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (*d*) performs merely clerical functions incident to the lease, license, sale, or exchange or (*e*) exercises final approval over the execution of the lease, license, sale, or exchange. The application of this subdivision may be illustrated by the following examples:

Example (1). F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licensees are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.

Example (2). N, a foreign corporation, is engaged in the active conduct of the business of distributing motion picture films and television programs. N does not distribute such films or programs in the United States. The foreign distribution rights to these films and programs are acquired by N's U.S. business office from the U.S. owners of these films and programs. Employees of N's offices located in various foreign countries carry on in such countries all the solicitations and negotiations for the licensing of these films and programs to licensees located in such countries and provide the necessary incidental services to the licensees. N's U.S. office collects the rentals from the foreign licensees and maintains the necessary records of income and expense. Officers of N located in the United States also maintain general supervision over the employees of the foreign offices, but the foreign employees conduct the day to day business of N outside the United States of soliciting, negotiating, or performing other activities required to arrange the foreign licenses. None of the income, gain, or loss resulting from the foreign licenses so negotiated by N is attributable to N's U.S. office.

(ii) *Dividends or interest, or gains or losses from sales of stock or securities—(a) In general.* Dividends or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities, specified in paragraph (b)(2) of § 1.864-5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the issue, acquisition, sale, or exchange, of the asset from which such income, gain, or loss is derived or performs significant services incident to such issue, acquisition, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (*1*) Collects or accounts for the dividends, interest, gains, or losses, (*2*) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (*3*) performs merely clerical functions incident to the issue, acquisition, sale, or exchange, or (*4*) exercises final approval over the execution of the issue, acquisition, sale, or exchange.

(*b*) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business.* Notwithstanding (*a*) of this subdivision (ii), the determination as to whether any dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources without the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States, shall be treated as effectively connected for such year with the active conduct of that business shall be made by applying the principles of paragraph (c)(5)(ii) of § 1.864-4 for determining whether income, gain, or loss of such type from sources within the United States is effectively connected for such year with the active conduct of that business.

(*c*) *Security defined.* For purposes of this subdivision (ii), a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe or to purchase, any of the foregoing items.

(*d*) *Limitations on application of rules on banking, financing, or similar business*—(*1*) *Trading for taxpayer's own account.* The provisions of (*b*) of this subdivision (ii) apply for purposes of determining when certain income, gain, or loss from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources without the United States which by reason of the application of (*b*) of this subdivision (ii) is not effectively connected with the active conduct by a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under (*a*) of this subdivision (ii), with the conduct by such taxpayer of a trade or business in the United States which consists of trading in stocks or securities for the taxpayer's own account.

(*2*) *Other income.* For rules relating to dividends or interest from sources without the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in (*b*) of this subdivision (ii)) derived in the active conduct of a banking, financing, or similar business in the United States, see (*a*) of this subdivision (ii).

(iii) *Sale of goods or merchandise through U.S. office.* Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864-5, if the office or other fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. The office or other fixed place of business in the United States shall be considered a material factor in the realization of income, gain, or loss from a sale made as a result of a sales order received in such office or other fixed place of business except where the sales order is received unsolicited and that office or other fixed place of business is not held out to potential customers as the place to which such sales orders should be sent. The income, gain, or loss must be realized in the ordinary course of the trade or business carried on through the office or other fixed place of business in the United States. Thus, if a foreign corporation is engaged solely in a manufacturing business in the United States, the income derived by its office in the United States as a result of an occasional sale outside the United States is not attributable to the U.S. office if the sales office of the manufacturing business is located outside the United States. On the other hand, if a foreign corporation establishes a sales office in the United States to sell for consumption in the Western Hemisphere merchandise which the corporation produces in Africa, the income derived by the sales office in the United States as a result of an occasional sale made by it in Europe shall be attributable to the U.S. sales office. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because of one or more of the following activities: (*a*) The sale is made subject to the final approval of such office or other fixed place of business, (*b*) the property sold is held in, and distributed from, such office or other fixed place of business, (*c*) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, or (*d*) such office or other fixed place of business performs merely clerical functions incident to the sale. Activities carried on by employees of an office or other fixed place of business constitute activities of that office or other fixed place of business.

(3) *Limitation where foreign office is a material factor in realization of income*—(i) *Goods or merchandise destined for foreign use, consumption, or disposition.* Notwithstanding subparagraphs (1) and (2) of this paragraph, an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States shall not be considered, for purposes of paragraph (a) of this section, to be a material factor in the realization of income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864-5 if the property is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business, as defined in § 1.864-7, which such nonresident alien individual or foreign corporation has outside the United States participates materially in the sale. For this purpose an office or other fixed place of business which the taxpayer has outside the United States shall be considered to have participated materially in a sale made through the office or other fixed place of business in the United States if the office or other fixed place of business outside the United States actively participates in soliciting the order resulting in the sale, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and buyer. An office or other fixed place of business which the taxpayer has outside the United States shall not be considered to have participated materially in a sale merely because of one or more of the following activities: (*a*) *The sale is made subject to the final approval of such office or other fixed place of business,* (*b*) the property sold is held in, and distributed from, such office or other fixed place of business, (*c*) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, (*d*) such office or other fixed place of business is used for purposes of having title to the property pass outside the United States, or (*e*) such office or other fixed place of business performs merely clerical functions incident to the sale.

(ii) *Rules for determining country of use, consumption, or disposition*—(*a*) *In general.* As a general rule, personal property which is sold to an unrelated person shall be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of property shall not cause that country to be considered the country of destination. However, if at the time of a sale of personal property to an unrelated person the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the taxpayer must determine the country of ultimate use, consumption, or disposition of the property or the property shall be presumed to have been sold for use, consumption, or disposition in the United States. A taxpayer who sells personal property to a related person shall be presumed to have sold the property for use, consumption, or disposition in the United States unless the taxpayer establishes the use made of the property by the related person; once he has established that the related person has disposed of the property, the rules in the two immediately preceding sentences relating to sales to an unrelated person shall apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person. Notwithstanding the preceding provisions of this subdivision (*a*), a taxpayer who sells personal property to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the United States may assume at the time of the sale to that person that the property will be used, consumed, or disposed of outside the United States. For purposes of this (*a*), a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons own or control directly or indirectly both. For this purpose, the term "control" includes any kind of control, whether or not legally enforceable, and however, exercised or exercisable. For illustrations of the principles of this subdivision, see paragraph (a)(3)(iv) of § 1.954-3.

(*b*) *Fungible goods.* For purposes of this subparagraph, a taxpayer who sells to a purchaser personal property which because of its fungible nature cannot reasonably be specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless the taxpayer establishes a different disposition as being proper, treat that property as being sold, for ultimate use, consumption, or disposition in those countries, and to those other purchasers, in the same proportions in which property from the fungible mass of the first purchaser is sold in the ordinary course of business by such first purchaser. No apportionment is required to be made, however, on the basis of sporadic sales by the first purchaser. This (*b*) shall apply only in a case where the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of property from the fungible mass.

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. Foreign corporation M has a sales office in the United States during the taxable year through which it sells outside the United States for use in foreign countries industrial electrical generators which such corporation manufactures in a foreign country. M is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, and, by reason of its activities in the United States, is engaged in business in the United States during the taxable year. The generators require specialized installation and continuous adjustment and maintenance services. M has an office in foreign country X which is the only organization qualified to perform these installation, adjustment, and maintenance services. During the taxable year M sells several generators through its U.S. office for use in foreign country Y under sales contracts which also provide for installation, adjustment, and maintenance by its office in country X. The generators are installed in country Y by employees of M's office in country X, who also are responsible for the servicing of the equipment. Since the office of M in country X performs significant services incident to these sales which are necessary for their consummation and are not the subject of a separate agreement between M and the purchaser, the U.S. office of M is not considered to be a material factor in the realization of the income from the sales and, for purposes of paragraph (a) of this section, such income is not attributable to the U.S. office of that corporation.

(c) *Amount of income, gain, or loss allocable to U.S. office*—(1) *In general.* If, in accordance with paragraph (b) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States at some time during the taxable year is a material factor in the realization for that year of an item of income, gain, or loss specified in paragraph (b) of § 1.864-5, such item of income, gain, or loss shall be considered to be allocable in its entirety to that office or other fixed place of business. In no case may any income, gain, or loss for the taxable year from sources without the United States, or part thereof, be allocable under this paragraph to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States if the taxpayer is at no time during the taxable year engaged in a trade or business in the United States.

(2) *Special limitation in case of sales of goods or merchandise through U.S. office.* Notwithstanding subparagraph (1) of this paragraph, in the case of a sale of goods or merchandise specified in paragraph (b)(3) of § 1.864-5, which is not a sale to which paragraph (b)(3)(i) of this section applies, the amount of income which shall be considered to be allocable to the office or other fixed place of business which the nonresident alien individual or foreign corporation has in the United States shall not exceed the amount which would be treated as income from sources within the United States if the taxpayer had sold the goods or merchandise in the United States. See, for example, section 863(b)(2) and paragraph (b) of § 1.863-3, which prescribes, as available methods for determining the income from sources within the United States, the independent factory or production price method, the gross sales and property apportionment method, and any other method regularly employed by the taxpayer which more clearly reflects taxable income from such sources than those specifically authorized.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation M, which is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, manufactures machinery in a foreign country and sells the machinery outside the United States through its sales office in the United States for use in foreign countries. Title to the property which is sold is transferred to the foreign purchaser outside the United States, but no office or other fixed place of business of M in a foreign country participates materially in the sale made through its U.S. office. During the taxable year M derives a total taxable income (determined as though M were a domestic corporation) of $250,000 from these sales. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would have been $100,000, determined as provided in section 863 and 882(c) and the regulations thereunder. The taxable income which is allocable to M's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business within the United States by that corporation is $100,000.

Example (2). Foreign corporation N, which is not a controlled foreign corporation within the meaning of section 957 and the regulations thereunder, has an office in a foreign country which purchases merchandise and sells it through its sales office in the United States for use in various foreign countries, such sales being made outside the United States and title to the property passing outside the United States. No other office of N participates materially in these sales made through its U.S. office. By reason of its sales activities in the United States, N is engaged in business in the United States during the taxable year. During the taxable year N derives taxable income (determined as though N were a domestic corporation) of $300,000 from these sales made through its U.S. sales office. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would also have been $300,000, determined as provided in sections 861 and 882(c) and the regulations thereunder. The taxable income which is allocable to N's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation is $300,000.

Example (3). The facts are the same as in example (2), except that N has an office in a foreign country which participates materially in the sales which are made through its U.S. office. The taxable income which is allocable to N's U.S. sales office is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

[T.D. 7216, 37 FR 23431, Nov. 3, 1972]

§ 1.864-7 Definition of office or other fixed place of business.

(a) *In general.* (1) This section applies for purposes of determining whether a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, has an office or other fixed place of business in the United States for purposes of applying section 864(c)(4)(B) and § 1. 864-6 to income, gain, or loss specified in paragraph (b) of § 1.864-5 from sources without the United States or has an office or other fixed place of business outside the United States for purposes of applying section 864(c)(4)(B)(iii) and paragraph (b)(3)(i) of § 1.864-6 to sales of goods or merchandise for use, consumption, or disposition outside the United States.

(2) In making a determination under this section due regard shall be given to the facts and circumstances of each case, particularly to the nature of the taxpayer's trade or business and the physical facilities actually required by the taxpayer in the ordinary course of the conduct of his trade or business.

(3) The law of a foreign country shall not be controlling in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business.

(b) *Fixed facilities*—(1) *In general.* As a general rule, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which a nonresident alien individual or a foreign corporation engages in a trade or business. For this purpose an office or other fixed place of business shall include, but shall not be limited to, a factory; a store or other sales outlet; a workshop; or a mine, quarry, or other place of extraction of natural resources. A fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by a nonresident alien individual or foreign corporation.

(2) *Use of another person's office or other fixed place of business.* A nonresident alien individual or a foreign corporation shall not be considered to have an office or other fixed place of business merely because such alien individual or foreign corporation uses another person's office or other fixed place of business, whether or not the office or place of business of a related person, through which to transact a trade or business, if the trade or business activities of the alien individual or foreign corporation in that office or other fixed place of business are relatively sporadic or infrequent, taking into account the overall needs and conduct of that trade or business.

(c) *Management activity.* A foreign corporation shall not be considered to have an office or other fixed place of business merely because a person controlling that corporation has an office or other fixed place of business from which general supervision and control over the policies of the foreign corporation are exercised. The fact that top management decisions affecting the foreign corporation are made in a country shall not of itself mean that the foreign corporation has an office or other fixed place of business in that country. For example, a foreign sales corporation which is a wholly owned subsidiary of a domestic corporation shall not be considered to have an office or other fixed place of business in the United States merely because of the presence in the United States of officers of the domestic parent corporation who are generally responsible only for the policy decisions affecting the foreign sales corporation, provided that the foreign corporation has a chief executive officer, whether or not he is also an officer of the domestic parent corporation, who conducts the day-to-day trade or business of the foreign corporation from a foreign office. The result in this example would be the same even if the executive officer should (1) regularly confer with the officers of the domestic parent corporation, (2) occasionally visit the U.S. office of the domestic parent corporation, and (3) during such visits to the United States temporarily conduct the business of the foreign subsidiary corporation out of the domestic parent corporation's office in the United States.

(d) *Agent activity*—(1) *Dependent agents*—(i) *In general.* In determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of an agent who is not an independent agent, as defined in subparagraph (3) of this paragraph, shall be disregarded unless such agent (*a*) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation, and regularly exercises that authority, or (*b*) has a stock of merchandise belonging to the nonresident alien individual or foreign corporation from which orders are regularly filed on behalf of such alien individual or foreign corporation. A person who purchases goods from a nonresident alien individual or a foreign corporation shall not be considered to be an agent for such alien individual or foreign corporation for purposes of this paragraph where such person is carrying on such purchasing activities in the ordinary course of its own business, even though such person is related in some manner to the nonresident alien individual or foreign corporation. For example, a wholly owned domestic subsidiary corporation of a foreign corporation shall not be treated as an agent of the foreign parent corporation merely because the subsidiary corporation purchases goods from the foreign parent corporation and resells them in its own name. However, if the domestic subsidiary corporation regularly negotiates and concludes contracts in the name of its foreign parent corporation or maintains a stock of merchandise from which it regularly fills orders on behalf of the foreign parent corporation, the office or other fixed place of business of the domestic subsidiary corporation shall be treated as the office or other fixed place of business of the foreign parent corporation unless the domestic subsidiary corporation is an independent agent within the meaning of subparagraph (3) of this paragraph.

(ii) *Authority to conclude contracts or fill orders.* For purposes of subdivision (i) of this subparagraph, an agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. This determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity. An agent shall not be considered regularly to negotiate and conclude contracts on behalf of his foreign principal if the agent's authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected.

(2) *Independent agents.* The office or other fixed place of business of an independent agent, as defined in subparagraph (3) of this paragraph, shall not be treated as the office or other fixed place of business of his principal who is a nonresident alien individual or a foreign corporation, irrespective of whether such agent has authority to negotiate and conclude contracts in the name of his principal, and regularly exercises that authority, or maintains a stock of goods from which he regularly fills orders on behalf of his principal.

(3) *Definition of independent agent*—(i) *In general.* For purposes of this paragraph, the term "independent agent" means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity. Thus, for example, an agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise consigned or entrusted to his possession, management, and control for that purpose by or for the owner of such goods or merchandise is an independent agent.

(ii) *Related persons.* The determination of whether an agent is an independent agent for purposes of this paragraph shall be made without regard to facts indicating that either the agent or the principal owns or controls directly or indirectly the other or that a third person or persons own or control directly or indirectly both. For example, a wholly owned domestic subsidiary corporation of a foreign corporation which acts an an agent for the foreign parent corporation may be treated as acting in the capacity of independent agent for the foreign parent corporation. The facts and circumstances of a specific case shall determine whether the agent, while acting for his principal, is acting in pursuance of his usual trade or business and in such manner as to constitute him an independent agent in his relations with the nonresident alien individual or foreign corporation.

(iii) *Exclusive agents.* Where an agent who is otherwise an independent agent within the meaning of subdivision (i) of this subparagraph acts in such capacity exclusively, or almost exclusively, for one principal who is a nonresident alien individual or a foreign corporation, the facts and circumstances of a particular case shall be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.

(e) *Employee activity.* Ordinarily, an employee of a nonresident alien individual or a foreign corporation shall be treated as a dependent agent to whom the rules of paragraph (d)(1) of this section apply if such employer does not in and of itself have a fixed facility (as defined in paragraph (b) of this section) in the United States or outside the United States, as the case may be. However, where the employee, in the ordinary course of his duties, carries on the trade or business of his employer in or through a fixed facility of such employer which is regularly used by the employee in the course of carrying out such duties, such fixed facility shall be considered the office or other fixed place of business of the employer, irrespective of the rules of paragraph (d)(1) of this section. The application of this paragraph may be illustrated by the following example:

Example. M, a foreign corporation, opens a showroom office in the United States for the purpose of promoting its sales of merchandise which it purchases in foreign country X. The employees of the U.S. office, consisting of salesmen and general clerks, are empowered only to run the office, to arrange for the appointment of distributing agents for the merchandise offered by M, and to solicit orders generally. These employees do not have the authority to negotiate and conclude contracts in the name of M, nor do they have a stock of merchandise from which to fill orders on behalf of M. Any negotiations entered into by these employees are under M's instructions and subject to its approval as to any decision reached. The only independent authority which the employees have is in the appointment of distributors to whom M is to sell merchandise, but even this authority is subject to the right of M to approve or disapprove these buyers on receipt of information as to their business standing. Under the circumstances, this office used by a group of salesmen for sales promotion is a fixed place of business which M has in the United States.

(f) *Office or other fixed place of business of a related person.* The fact that a nonresident alien individual or a foreign corporation is related in some manner to another person who has an office or other fixed place of business shall not of itself mean that such office or other fixed place of business of the other person is the office or other fixed place of business of the nonresident alien individual or foreign corporation. Thus, for example, the U.S. office of foreign corporation M, a wholly owned subsidiary corporation of foreign corporation N, shall not be considered the office or other fixed place of business of N unless the facts and circumstances show that N is engaged in trade or business in the United States through that office or other fixed place of business. However, see paragraph (b)(2) of this section.

(g) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). S, a foreign corporation, is engaged in the business of buying and selling tangible personal property. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling similar property, which has an office in the United States. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has an independent group of officers, none of whom are regularly employed in the United States. In addition to this group of officers, S has a chief executive officer, D, who is also an officer of P but who is permanently stationed outside the United States. The day-to-day conduct of S's business is handled by D and the other officers of such corporation, but they regularly confer with the officers of P and on occasion temporarily visit P's offices in the United States, at which time they continue to conduct the business of S. S does not have an office or other fixed place of business in the United States for purposes of this section.

Example (2). The facts are the same as in example (1) except that, on rare occasions, an employee of P receives an order which he, after consultation with officials of S and because P cannot fill the order, accepts on behalf of S rather than on behalf of P. P does not hold itself out as a person which those wishing to do business with S should contact. Assuming that orders for S are seldom handled in this manner and that they do not constitute a significant part of that corporation's business, S shall not be considered to have an office or other fixed place of business in the United States because of these activities of an employee of P.

Example (3). The facts are the same as in example (1) except that all orders received by S are subject to review by an officer of P before acceptance. S has a business office in the United States.

Example (4). S, a foreign corporation organized under the laws of Puerto Rico, is engaged in the business of manufacturing dresses in Puerto Rico and is entitled to an income tax exemption under the Puerto Rico Industrial Incentive Act of 1963. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of buying and selling dresses to customers in the United States. S sells most of the dresses it produces to P, the assumption being made that the income from these sales is derived from sources without the United States. P in turn sells these dresses in the United States in its name and through the efforts of its own employees and of distributors appointed by it. S does not have a fixed facility in the United States, and none of its employees are stationed in the United States. On occasion, employees of S visit the office of P in the United States, and executives of P visit the office of S in Puerto Rico, to discuss with one another matters of mutual business interest involving both corporations, including the strategy for marketing the dresses produced by S. These matters are also regularly discussed by such persons by telephone calls between the United States and Puerto Rico. S's employees do not otherwise participate in P's marketing activities. Officers of P are generally responsible for the policies followed by S and are directors of S, but S has a chief executive officer in Puerto Rico who, from its office therein, handles the day-to-day conduct of S's business. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example (5). The facts are the same as in example (4) except that the dresses are manufactured by S in styles and designs furnished by P and out of goods and raw materials purchased by P and sold to S. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

Example (6). The facts are the same as in example (5) except that, pursuant to the instructions of P, the dresses sold by P are shipped by S directly to P's customers in the United States. Based upon the facts presented, and assuming there are no other facts which would lead to a different determination, S shall not be considered to have an office or other fixed place of business in the United States for purposes of this section.

[T.D. 7216, 37 FR 23433, Nov. 3, 1972]

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871-1 Classification and manner of taxing alien individuals.

(a) *Classes of aliens.* For purposes of the income tax, alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident alien individuals are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. See § 1.1-1(b). Nonresident alien individuals are taxable only on certain income from sources within the United States and on the income described in section 864(c)(4) from sources without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States. However, nonresident alien individuals may elect, under section 6013 (g) or (h), to be treated as U.S. residents for purposes of determining their income tax liability under chapters 1, 5, and 24 of the code. Accordingly, any reference in §§ 1.1-1 through 1.1388-1 and §§ 1.1491-1 through 1.1494-1 of this part to non-resident alien individuals does not include those with respect to whom an election under section 6013 (g) or (h) is in effect, unless otherwise specifically provided. Similarly, any reference to resident aliens or U.S. residents includes those with respect to whom an election is in effect, unless otherwise specifically provided.

(b) *Classes of nonresident aliens*—(1) *In general.* For purposes of the income tax, nonresident alien individuals are divided into the following three classes:

(i) Nonresident alien individuals who at no time during the taxable year are engaged in a trade or business in the United States,

(ii) Nonresident alien individuals who at any time during the taxable year are, or are deemed under § 1.871-9 to be, engaged in a trade or business in the United States, and

(iii) Nonresident alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

An individual described in subdivision (i) or (ii) of this subparagraph is subject to tax pursuant to the provisions of subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder. See §§ 1.871-7 and 1.871-8. The provisions of subpart A do not apply to individuals described in subdivision (iii) of this subparagraph, but such individuals, except as provided in section 933 with respect to Puerto Rican source income, are subject to the tax imposed by section 1 or section 1201(b). See § 1.876-1.

(2) *Treaty income.* If the gross income of a nonresident alien individual described in subparagraph (1) (i) or (ii) of this paragraph includes income on which the tax is limited by tax convention, see § 1.871-12.

(3) *Exclusions from gross income.* For rules relating to the exclusion of certain items from the gross income of a nonresident alien individual, including annuities excluded under section 871(f), see §§ 1.872-2 and 1.894-1.

(4) *Expatriation to avoid tax.* For special rules applicable in determining the tax of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877.

(5) *Adjustment of tax of certain nonresident aliens.* For the application of pre-1967 income tax provisions to residents of a foreign country which imposes a more burdensome income tax than the United States, and for the adjustment of the income tax of a national or resident of a foreign country which imposes a discriminatory income tax on the income of citizens of the United States or domestic corporations, see section 896.

(6) *Citizens of certain U.S. possessions.* For rules for treating as nonresident alien individuals certain citizens of possessions of the United States who are not otherwise citizens of the United States, see section 932 and § 1.932-1.

(c) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871-1 and 1.871-7(a) (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44218, Dec. 23, 1974; as amended by T.D. 7670, 45 FR 6928, Jan 31, 1980]

§ 1.871-2 Determining residence of alien individuals.

(a) *General.* The term "nonresident alien individual" means an individual whose residence is not within the United States, and who is not a citizen of the United States. The term includes a nonresident alien fiduciary. For such purpose the term "fiduciary" shall have the meaning assigned to it by section 7701(a)(6) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). For presumption as to an alien's nonresidence, see paragraph (b) of § 1.871-4.

(b) *Residence defined.* An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

§ 1.871-3 Residence of alien seamen.

In order to determine whether an alien seaman is a resident of the United States for purposes of the income tax, it is necessary to decide whether the presumption of nonresidence (as prescribed by paragraph (b) of § 1.871-4) is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel which is flying the United States flag and is engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in § 1.871-4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient.

§ 1.871-4 Proof of residence of aliens.

(a) *Rules of evidence.* The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein for purposes of the income tax.

(b) *Nonresidence presumed.* An alien by reason of his alienage, is presumed to be a nonresident alien.

(c) *Presumption rebutted*—(1) *Departing alien.* In the case of an alien who presents himself for determination of tax liability before departure from the United States, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien, at least six months before the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien, at least six months before the date he so presents himself, has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(2) *Other aliens.* In the case of other aliens, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(d) *Certificate.* If, in the application of paragraphs (c)(1)(iii) or (2)(iii) of this section, the internal revenue officer or employee who examines the alien is in doubt as to the facts, such officer or employee may, to assist him in determining the facts, require a certificate or certificates setting forth the facts relied upon by the alien seeking to overcome the presumption. Each such certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months before the date of execution of the certificate or certificates.

§ 1.871-5 Loss of residence by an alien.

An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

§ 1.871-6 Duty of withholding agent to determine status of alien employees.

(a) *Proof of status required.* If income is paid to an alien individual without withholding the tax under chapter 3 of the Code, except insofar as the regulations thereunder permit exemption from withholding, then the withholding agent must be prepared to justify the failure to withhold.

(b) *Evidence of residence.* A withholding agent may rely upon the evidence of residence afforded by the fact that the alien individual has filed Form 1078 or an equivalent written statement. This statement or form shall be filed in the manner prescribed in § 1.1441-5.

(c) *Cross reference.* For definition of the term "withholding agent," see § 1.1465-1.

(d) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871-6 (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44218, Dec. 23, 1974]

§ 1.871-7 Taxation of nonresident alien individuals not engaged in U.S. business.

(a) *Imposition of tax.* (1) This section applies for purposes of determining the tax of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States. However, see also § 1.871-8 where such individual is a student or trainee deemed to be engaged in trade or business in the United States or where he has an election in effect for the taxable year in respect to real property income. Except as otherwise provided in § 1.871-12, a nonresident alien individual to whom this section applies is not subject to the tax imposed by section 1 or section 1201(b) but, pursuant to the provision of section 871(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b), (c), and (d) of this section which are received during the taxable year from sources within the United States. Except as specifically provided in such paragraphs, such amounts do not include gains from the sale or exchange of property. To determine the source of such amounts, see sections 861 through 863, and the regulations thereunder.

(2) The tax of 30 percent is imposed by section 871(a) upon an amount only to the extent the amount constitutes gross income. Thus, for example, the amount of an annuity which is subject to such tax shall be determined in accordance with section 72.

(3) Deductions shall not be allowed in determining the amount subject to tax under this section except that losses from sales or exchanges of capital assets shall be allowed to the extent provided in section 871(a)(2) and paragraph (d) of this section.

(4) Except as provided in §§ 1.871-9 and 1.871-10, a nonresident alien individual not engaged in trade or business in the United States during the taxable year has no income, gain, or loss for the taxable year which is effectively connected for the taxable year with the conduct of a trade or business in the United States. See section 864(c)(1)(B) and § 1.864-3.

(5) Gains and losses which, by reason of section 871(d) and § 1.871-10,

are treated as gains or losses which are effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual shall not be taken into account in determining the tax under this section. See, for example, paragraph (c)(2) of § 1.871-10.

(6) For special rules applicable in determining the tax of certain nonresident alien individuals, see paragraph (b) of § 1.871-1.

(b) *Fixed or determinable annual or periodical income.* The tax of 30 percent imposed by section 871(a)(1) applies to the gross amount received from sources within the United States as fixed or determinable annual or periodical gains, profits, or income. Specific items of fixed or determinable annual or periodical income are enumerated in section 871(a)(1)(A) as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other items of fixed or determinable annual or periodical gains, profits, or income are also subject to the tax, as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. As to the determination of fixed or determinable annual or periodical income see paragraph (a) of § 1.1441-2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income for purposes of section 871(a), see section 306(f) and paragraph (h) of § 1.306-3.

(c) *Other income and gains*—(1) *Items subject to tax.* The tax of 30 percent imposed by section 871(a)(1) also applies to the following gains received during the taxable year from sources within the United States:

(i) Gains described in section 402(a)(2), relating to the treatment of total distributions from certain employees' trusts; section 403(a)(2), relating to treatment of certain payments under certain employee annuity plans; and section 631 (b) or (c), relating to treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains on transfers described in section 1235, relating to certain transfers of patent rights, made on or before October 4, 1966; and

(iv) Gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, or other like property, or of any interest in any such property, to the extent the gains are from payments (whether in a lump sum or in installments) which are contingent on the productivity, use or disposition of the property or interest sold or exchanged, or from payments which are treated under section 871(e) and § 1.871-11 as being so contingent.

(2) *Nonapplication of 183-day rule.* The provisions of section 871(a)(2), relating to gains from the sale or exchange of capital assets, and paragraph (d)(2) of this section do not apply to the gains described in this paragraph; as a consequence, the taxpayer receiving gains described in subparagraph (1) of this paragraph during a taxable year is subject to the tax of 30 percent thereon without regard to the 183-day rule contained in such provisions.

(3) *Determination of amount of gain.* The tax of 30 percent imposed upon the gains described in subparagraph (1) of this paragraph applies to the full amount of the gains and is determined (i) without regard to the alternative tax imposed by section 1201(b) upon the excess of the net long-term capital gain over the net short-term capital loss; (ii) without regard to the deduction allowed by section 1202 in respect of capital gains; (iii) without regard to section 1231, relating to property used in the trade or business and involuntary conversions; and (iv), except in the case of gains described in subparagraph (1)(ii) of this paragraph, whether or not the gains are considered to be gains from the sale or exchange of property which is a capital asset.

(d) *Gains from sale or exchange of capital assets*—(1) *Gains subject to tax.* The tax of 30 percent imposed by section 871(a)(2) applies to the excess of gains derived from sources within the United States over losses allocable to sources within the United States, which are derived from the sale or exchange of capital assets, determined in accordance with the provisions of subparagraphs (2) through (4) of this paragraph.

(2) *Presence in the United States 183 days or more.* (i) If the nonresident alien individual has been present in the United States for a period or periods aggregating 183 days or more during the taxable year, he is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during the year exceed his losses, allocable to sources within the United States, from sales or exchanges of capital assets effected at any time during that year. Gains and losses from sales or exchanges effected at any time during such taxable year are to be taken into account for this purpose even though the nonresident alien individual is not present in the United States at the time the sales or exchanges are effected. In addition, if the nonresident alien individual has been present in the United States for a period or periods aggregating 183 days or more during the taxable year, gains and losses for such taxable year from sales or exchanges of capital assets effected during a previous taxable year beginning after December 31, 1966, are to be taken into account, but only if he was also present in the United States during such previous taxable year for a period or periods aggregating 183 days or more.

(ii) If the nonresident alien individual has not been present in the United States during the taxable year, or if he has been present in the United States for a period or periods aggregating less than 183 days during the taxable year, gains and losses from sales or exchanges of capital assets effected during the year are not to be taken into account, except as required by paragraph (c) of this section, in determining the tax of such individual even though the sales or exchanges are effected during his presence in the United States. Moreover, gains and losses for such taxable year from sales or exchanges of capital assets effected during a previous taxable year beginning after December 31, 1966, are not to be taken into account, even though the nonresident alien individual was present in the United States during such previous year for a period or periods aggregating 183 days or more.

(iii) For purposes of this subparagraph, a nonresident alien individual is not considered to be present in the United States by reason of the presence in the United States of a person who is an agent or partner of such individual or who is a fiduciary of an estate or trust of which such individual is a beneficiary or a grantor-owner to whom section 671 applies.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1) B, a nonresident alien individual not engaged in trade or business in the United States and using the calendar year as the taxable year, is present in the United States from May 1, 1971, to November 15, 1971, a period of more than 182 days. While present in the United States, B effects for his own account on various dates a number of transactions in stocks and securities on the stock exchange, as a result of which he has recognized capital gains of $10,000. During the period from January 1, 1971, to April 30, 1971, he carries out similar transactions through an agent in the United States, as a result of which B has recognized capital gains of $5,000. On December 15, 1971, through an agent in the United States B sells a capital asset on the installment plan, no payments being made by the purchaser in 1971. During 1972, B receives installment payments of $50,000 on the installment sale made in 1971, and the capital gain from sources within the United States for 1972 attributable to such payments is $12,500. In addition, during the period from January 1, 1972, to May 31, 1972, B effects for his own account, through an agent in the United States, a number of transactions in stocks and securities on the stock exchange, as a result of which B has recognized capital gains of $20,000. At no time during 1972 is B present in the United States or engaged in trade or business in the United States. Accordingly, for 1971, B is subject to tax under section 871(a)(2) on his capital gains of $15,000 from the transactions in that year on the stock exchange. For 1972, B is not subject to tax on the capital gain of $12,500 from the installment sale in 1971 or on the capital gains of $20,000 from the transactions in 1972 on the stock exchange.

Example (2). The facts are the same as in example (1) except that B is present in the United States from June 15, 1972, to December 31, 1972, a period of more than 182 days. Accordingly, B is subject to tax under section 871(a)(2) for 1971 on his capital gains of $15,000 from the transactions in that year on the stock exchange. He is also subject to tax under section 871(a)(2) for 1972 on his capital gains of $32,500 ($12,500 from the installment sale in 1971 plus $20,000 from the transactions in 1972 on the stock exchange).

Example (3). D, a nonresident alien individual not engaged in trade or business in the United States and using the calendar year as the taxable year, is present in the United States from April 1, 1971, to August 31, 1971, a period of less than 183 days. While present in the United States, D effects for his own account on various dates a number of transactions in stocks and securities on the stock exchange, as a result of which he has recognized capital gains of $15,000. During the period from January 1, 1971, to March 31, 1971, he carries out similar transactions through an agent in the United States, as a result of which D has recognized capital gains of $8,000. On December 20, 1971, through an agent in the United States D sells a capital asset on the installment plan, no payments being made by the purchaser in 1971. During 1972, D receives installment payments of $200,000 on the installment sale made in 1971, and the capital gain from sources within the United States for 1972 attributable to such payments is $50,000. In addition, during the period from February 1, 1972, to August 15, 1972, a period of more than 182 days, D effects for his own account, through an agent in the United States, a number of transactions in stocks and securities on the stock exchange, as a result of which D has recognized capital gains of $25,000. At no time during 1972 is D present in the United States or engaged in trade or business in the United States. Accordingly, D is not subject to tax for 1971 or 1972 on any of his recognized capital gains.

Example (4). The facts are the same as in example (3) except that D is present in the United States from February 1, 1972, to August 15, 1972, a period of more than 182 days. Accordingly, D is not subject to tax for 1971 on his capital gains of $23,000 from the transactions in that year on the stock exchange. For 1972 he is subject to tax under section 871(a)(2) on his capital gains of $25,000 from the transactions in that year on the stock exchange, but he is not subject to the tax on the capital gain of $50,000 from the installment sale in 1971.

(3) *Determination of 183-day period*—(i) *In general.* In determining the total period of presence in the United States for a taxable year for purposes of subparagraph (2) of this paragraph, all separate periods of presence in the United States during the taxable year are to be aggregated. If the nonresident alien individual has not previously established a taxable year, as defined in section 441(b), he shall be treated as having a taxable year which is the calendar year, as defined in section 441(d). Subsequent adoption by such individual of a fiscal year as the taxable year will be treated as a change in the taxpayer's annual accounting period to which section 442 applies, and the change must be authorized under this part (Income Tax Regulations) or prior approval must be obtained by filing an application on Form 1128 in accordance with paragraph (b) of § 1.442-1. If in the course of his taxable year the nonresident alien individual changes his status from that of a citizen or resident of the United States to that of a nonresident alien individual, or vice versa, the determination of whether the individual has been present in the United States for 183 days or more during the taxable year shall be made by taking into account the entire taxable year, and not just that part of the taxable year during which he has the status of a nonresident alien individual.

(ii) *Definition of "day".* The term "day", as used in subparagraph (2) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States (within the meaning of sections 7701(a)(9) and 638) except that, in the case of an individual who is a resident of Canada or Mexico and, in the normal course of his employment in transportation service touching points within both Canada or Mexico and the United States, performs personal services in both the foreign country and the United States, the following rules shall apply:

(*a*) The performance of labor or personal services during 8 hours or more in any 1 day within the United States shall be considered as 1 day in the United States, except that if a period of more or less than 8 hours is considered a full workday in the transportation job involved, such period shall be considered as 1 day within the United States.

(*b*) The performance of labor or personal services during less than 8 hours in any day in the United States shall, except as provided in (*a*) of this subdivision, be considered as a fractional part of a day in the United States. The total number of hours during which such services are performed in the United States during the taxable year, when divided by eight, shall be the number of days during which such individual shall be considered present in the United States during the taxable year.

(*c*) The aggregate number of days determined under (*a*) and (*b*) of this subdivision shall be considered the total number of days during which such individual is present in the United States during the taxable year.

(4) *Determination of amount of excess gains*—(i) *In general.* For the purpose of determining the excess of gains over losses subject to tax under this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if the nonresident alien individual were engaged in trade or business in the United States during the taxable year and such gains and losses were effectively connected for such year with the conduct of a trade or business in the United States by such individual. However, in determining such excess of gains over losses no deduction may be taken under section 1202, relating to the deduction for capital gains, or section 1212, relating to the capital loss carryover. Thus, for example, in determining such excess gains all amounts considered under chapter 1 of the Code as gains or losses from the sale or exchange of capital assets shall be taken into account, except those gains which are described in section 871(a)(1) (B) or (D) and taken into account under paragraph (c) of this section and are considered to be gains from the sale or exchange of capital assets. Also, for example, a loss described in section 631 (b) or (c) which is considered to be a loss from the sale of a capital asset shall be taken into account in determining the excess gains which are subject to tax under this paragraph. In further illustration, in determining such excess gains no deduction shall be allowed, pursuant to the provisions of section 267, for losses from sales or exchanges of property between related taxpayers. Any gains which are taken into account under section 871(a)(1) and paragraph (c) of this section shall not be taken into account in applying section 1231 for purposes of this paragraph. Gains and losses are to be taken into account under this paragraph whether they are short-term or long-term capital gains or losses within the meaning of section 1222.

(ii) *Gains not included.* The provisions of this paragraph do not apply to any gains described in section 871(a)(1) (B) or (D), and in subdivision (i), (iii), or (iv) of paragraph (c)(1) of this section, which are considered to be gains from the sale or exchange of capital assets.

(iii) *Allowance of losses.* In determining the excess of gains over losses subject to tax under this paragraph losses shall be allowed only to the extent provided by section 165(c). Losses from sales or exchanges of capital assets in excess of gains from sales or exchanges of capital assets shall not be taken into account.

(e) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), by section 32 (relating to tax withheld at source on nonresident aliens), by section 39 (relating to certain uses of gasoline and lubricating oil), and by section 6402 (relating to overpayments of tax) shall be allowed against the tax of a nonresident alien individual determined in accordance with this section.

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871-7 (b) and (c) (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44219, Dec. 23, 1974]

§ 1.871-8 Taxation of nonresident alien individuals engaged in U.S. business or treated as having effectively connected income.

(a) *Segregation of income.* This section applies for purposes of determining the tax of a nonresident alien individual who at any time during the taxable year is engaged in trade or business in the United States. It also applies for purposes of determining the tax of a nonresident alien student or trainee who is deemed under section 871(c) and § 1.871-9 to be engaged in trade or business in the United States or of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States but has an election in effect for the taxable year under section 871(d) and § 1.871-10 in respect to real property income. A nonresident alien individual to whom this section applies must segregate his gross income for the taxable year into two categories, namely (1) the income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and (2) the income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. A separate tax shall then be determined upon each such category of income, as provided in paragraph (b) of this section. The determination of whether income or gain is or is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual shall be made in accordance with section 864(*c*) and §§ 1.864-3 through 1.864-7. For purposes of this section income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 871 (c) or (d) and § 1.871-9 or § 1.871-10 as income which is effectively connected such year with the conduct of a trade or business in the United States by the nonresident alien individual.

(b) *Imposition of tax*—(1) *Income not effectively connected with the conduct of a trade or business in the United States.* If a nonresident alien individual who is engaged in trade or business in the United States at any time during the taxable year derives during such year from sources within the United States income or gains described in section 871(a)(1), and paragraph (b) or (c) of § 1.871-7 or gains from the sale or exchange of capital assets determined as provided in section 871(a)(2) and paragraph (d) of § 1.871-7, which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, such income or gains shall be subject to a flat tax of 30 percent of the aggregate amount of such items. This tax shall be determined in the manner, and subject to the same conditions, set forth in § 1.871-7 as though the income or gains were derived by a nonresident alien individual not engaged in trade or business in the United States during the taxable year, except that (i) the rule in paragraph (d)(3) of such section for treating the calendar year as the taxable year shall not apply and (ii) in applying paragraph (c) and (d)(4) of such section, there shall not be taken into account any gains or losses which are taken into account in determining the tax under section 871(b) and subparagraph (2) of this paragraph. A nonresident alien individual who has an election in effect for the taxable year under section 871(d) and § 1.871-10 and who at no time during the taxable year is engaged in trade or business in the United States must determine his tax under § 1.871-7 on his income which is not treated as effectively connected with the conduct of a trade or business in the United States, subject to the exception contained in subdivision (ii) of this subparagraph.

(2) *Income effectively connected with the conduct of a trade or business in the United States*—(i) *In general.* If a non- resident alien to whom this section applies derives income or gains which are effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, the taxable income or gains shall, except as provided in § 1.871-12, be taxed in accordance with section 1 or, in the alternative, section 1201(b). See section 871(b)(1). Any income of the nonresident alien individual which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual shall not be taken into account in determin-

ing either the rate or amount of such tax. See paragraph (b) of § 1.872-1.

(ii) *Determination of taxable income.* The taxable income for any taxable year for purposes of this subparagraph consists only of the nonresident alien individual's taxable income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual; and, for this purpose, it is immaterial that the trade or business with which that income is effectively connected is not the same as the trade or business carried on in the United States by that individual during the taxable year. See example (2) in § 1.864-4(b). In determining such taxable income all amounts constituting, or considered to be, gains or losses for the taxable year from the sale or exchange of capital assets shall be taken into account if such gains or losses are effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and, for such purpose, the 183-day rule set forth in section 871(a)(2) and paragraph (d)(2) of § 1.871-7 shall not apply. Losses which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual shall not be taken into account in determining taxable income under this subdivision, except as provided in section 873(b)(1).

(iii) *Cross references.* For rules for determining the gross income and deductions for the taxable year, see sections 872 and 873, and the regulations thereunder.

(c) *Change in trade or business status*—(1) *In general.* The determination as to whether a nonresident alien individual is engaged in trade or business within the United States during the taxable year is to be made for each taxable year. If at any time during the taxable year he is engaged in a trade or business in the United States, he is considered to be engaged in trade or business within the United States during the taxable year for purposes of sections 864(c)(1) and 871(b), and the regulations thereunder. Income, gain, or loss of a nonresident alien individual is not treated as being effectively connected for the taxable year with the conduct of a trade or business in the United States if he is not engaged in trade or business within the United States during such year, even though such income, gain, or loss may have been effectively connected for a previous taxable year with the conduct of a trade or business in the United States. See § 1.864-3. However, income, gain, or loss which is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual will generally be treated as effectively connected for a subsequent taxable year if he is engaged in a trade or business in the United States during such subsequent year, even though such income, gain, or loss is not effectively connected with the conduct of the trade or business carried on in the United States during such subsequent year. This subparagraph does not apply to income described in section 871 (c) or (d). It may not apply to a nonresident alien individual who for the taxable year uses an accrual method of accounting or to income which is constructively received in the taxable year within the meaning of § 1.451-2.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). B, a nonresident alien individual using the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is engaged in business (business R) in the United States from January 1, 1971, to August 31, 1971. During the period of September 1, 1971, to December 31, 1971, B receives installment payments of $30,000 on sales made in the United States by business R during that year, and the income from sources within the United States for that year attributable to such payments is $7,509. On September 15, 1971, another business (business S), which is carried on by B only in a foreign country sells to U.S. customers on the installment plan several pieces of equipment from inventory. During the period of September 16, 1971, to December 31, 1971, B receives installment payments of $50,000 on these sales by business S, and the income from sources within the United States for that year attributable to such payments is $10,000. Under section 864(c)(3) and paragraph (b) of § 1.864-4 the entire income of $17,500 is effectively connected for 1971 with the conduct of a business in the United States by B. Accordingly, such income is taxable to B under paragraph (b)(2) of this section.

Example (2). Assume the same facts as in example (1), except that during 1972 B receives installment payments of $20,000 from the sales made during 1971 in the United States by business R, and of $80,000 from the sales made in 1971 to U.S. customers by business S, the total income from sources within the United States for 1972 attributable to such payments being $13,000. At no time during 1972 is B engaged in a trade or business in the United States. Under section 864(c)(1)(B) the income of $13,000 for 1972 is not effectively connected with the conduct of a trade or business in the United States by B. Moreover, such income is not fixed or determinable annual or periodical income. Accordingly, no amount of such income is taxable to B under section 871.

Example (3). Assume the same facts as in example (2), except that during 1972 B is engaged in a new business (business T) in the United States from July 1, 1972, to December 31, 1972. Under section 864(c)(3) and paragraph (b) of § 1.864-4, the income of $13,000 is effectively connected for 1972 with the conduct of a business in the United States by B. Accordingly, such income is taxable to B under paragraph (b)(2) of this section.

Example (4). Assume the same facts as in example (2), except that the installment payments of $20,000 from the sales made during 1971 in the United States by business R and not received by B until 1972 could have been received by B in 1971 if he had so desired. Under § 1.451-2, B is deemed to have constructively received the payments of $20,000 in 1971. Accordingly, the income attributable to such payments is effectively connected for 1971 with the conduct of a business in the United States by B and is taxable to B in 1971 under paragraph (b)(2) of this section.

(d) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to the foreign tax credit), section 35 (relating to partially tax-exempt interest), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), section 40 (relating to expenses of work incentive programs), and section 6402 (relating to overpayments of tax) shall be allowed against the tax determined in accordance with this section. However, the credits allowed by sections 33, 38, and 40 shall not be allowed against the flat tax of 30 percent imposed by section 871(a) and paragraph (b)(1) of this section. Moreover, no credit shall be allowed under section 35 to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871(a) and paragraph (b)(1) of this section, even though such individual has income for such year upon which tax is imposed under section 871(b) and paragraph (b)(2) of this section. For special rules applicable in determining the foreign tax credit, see section 906(b) and the regulations thereunder. For the disallowance of certain credits where a return is not filed for the taxable year, see section 874 and § 1.874-1.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871-7(d) (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44221, Dec. 23, 1974]

§ 1.871-9 Nonresident alien students or trainees deemed to be engaged in U.S. business.

(a) *Participants in certain exchange or training programs.* For purposes of §§ 1.871-7 and 1.871-8 a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)), and who without regard to this paragraph is not engaged in trade or business in the United States during such year, shall be deemed to be engaged in trade or business in the United States during the taxable year. For purposes of determining whether an alien who is present in the United States on an F visa or a J visa is a resident of the United States, see § 1.871-2.

(b) *Income treated as effectively connected with U.S. business.* Any income described in paragraph (1) (relating to the nonexcluded portion of certain scholarship or fellowship grants) or paragraph (2) (relating to certain nonexcluded expenses incident to such grants) of section 1441(b) which is received during the taxable year from sources within the United States by a nonresident alien individual described in paragraph (a) of this section is to be treated for purposes of §§ 1.871-7, 1.871-8, 1.872-1, and 1.873-1 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. However, such income is not to be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States for purposes of section 1441(c)(1) and paragraph (a) of § 1.1441-4. For exclusion relating to compensation paid to such individual by a foreign employer, see paragraph (b) of § 1.872-2.

(c) *Exchange visitors.* For purposes of paragraph (a) of this section a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (J) of section 101(a)(15) of the Immigration and Nationality Act includes a nonresident alien individual admitted to the United States as an "exchange visitor" under section 201 of the U.S. Information and Educational Exchange Act of 1948 (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Educational and Cultural Exchange Act of 1961 (75 Stat. 538).

(d) *Mandatory application of rule.* The application of this section is mandatory and not subject to an election by the taxpayer.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871-7(a)(3) (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44222, Dec. 23, 1974]

§ 1.871-10 Election to treat real property income as effectively connected with U.S. business.

(a) *When election may be made.* A nonresident alien individual or foreign corporation which during the taxable year derives any income from real property which is located in the United States and, in the case of a nonresident alien individual, held for the production of income, or derives income from any interest in any such property, may elect, pursuant to section 871(d) or 882(d) and this section, to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that taxpayer. The election may be made whether or not the taxpayer is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the taxpayer has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States, but it may be made only with respect to that income from sources within the United States which, without regard to this section, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the taxpayer. If for the taxable year the taxpayer has no income from real property located in the United States, or from any interest in such property, which is subject to the tax imposed by section 871(a) or 881(a), the election may not be made. But if an election has been properly made under this section for a taxable year, the election remains in effect, unless properly revoked, for subsequent taxable years even though during any such subsequent taxable year there is no income from the real property, or interest therein, in respect of which the election applies.

(b) *Income to which the election applies*—(1) *Included income.* An election under this section shall apply to all income from real property which is located in the United States and, in the case of a nonresident alien individual, held for the production of income, and to all income derived from any interest in such property, including (i) gains from the sale or exchange of such property or an interest therein, (ii) rents or royalties from mines, oil or gas wells, or other natural resources, and (iii) gains described in section 631 (b) or (c), relating to treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest. The election may not be made with respect to only one class of such income. For purposes of the election, income from real property, or from any interest in real property, includes any amount included under section 652 or 662 in the gross income of a nonresident alien individual or foreign corporation that is the beneficiary of an estate or trust if, by reason of the application of section 652(b) or 662(b), and the regulations thereunder, such amount has the character in the hands of that beneficiary of income from real property, or from any interest in real property. It is immaterial that no tax would be imposed on the income by section 871(a) and paragraph (a) of § 1.871-7, or by section 881(a) and paragraph (a) of § 1.881-2, if the election were not in effect. Thus, for example, if an election under this section has been made by a nonresident alien individual not engaged in trade or business in the United States during the taxable year, the tax imposed by section 871(b)(1) and paragraph (b)(2) of § 1.871-8 applies to his gains derived from the sale of real property located in the United States and held for the production of income, even though such income would not be subject to tax under section 871(a) if the election had not been made. In further illustration, assume that a nonresident alien individual not engaged in trade or business, or present, in the United States during the taxable year has income from sources within the United States consisting of oil royalties, rentals from a former personal residence, and capital gain from the sale of another residence held for the production of income. If he makes an election under this section, it will apply with respect to his royalties, rentals, and capital gain, even though such capital gain would not be subject to tax under section 871(a) if the election had not been made.

(2) *Income not included.* For purposes of subparagraph (1) of this paragraph, income from real property, or from any interest in real property, does not include (i) interest on a debt obligation secured by a mortgage of real property, (ii) any portion of a dividend, within the meaning of section 316, which is paid by a corporation or a trust, such as a real estate investment trust described in section 857, which derives income from real property, (iii) in the case of a nonresident alien individual, income from real property, such as a personal residence, which is not held for the production of income or from any transaction in such property which was not entered into for profit, (iv) rentals from personal property, or royalties from intangible personal property, within the meaning of subparagraph (3) of this paragraph, or (v) income which, without regard to section 871(d) or 882(d) and this section, is treated as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(3) *Rules applicable to personal property.* For purposes of subparagraph (2) of this paragraph, in the case of a sales agreement, or rental or royalty agreement, affecting both real and personal property, the income from the transaction is to be allocated between the real property and the personal property in proportion to their respective fair market values unless the agreement specifically provides otherwise. In the case of such a rental or royalty agreement, the respective fair market values are to be determined as of the time the agreement is signed. In making determinations of this subparagraph, the principles of paragraph (c) of § 1.48-1, relating to the definition of "section 38 property," apply for purposes of determining whether property is tangible or intangible personal property and of paragraph (a)(5) of § 1.1245-1 apply for purposes of making the allocation of income between real and personal property.

(c) *Effect of the election*—(1) *Determination of tax.* The income to which, in accordance with paragraph (b) of this section, an election under this section applies shall be subject to tax in the manner, and subject to the same conditions, provided by section 871(b)(1) and paragraph (b)(2) of § 1.871-8, or by section 882(a)(1) and paragraph (b)(2) of § 1.882-1. For purposes of determining such tax for the taxable year, income to which the election applies shall be aggregated with all other income of the nonresident alien individual or foreign corporation which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that taxpayer. To the extent that deductions are connected with income from real property to which the election applies, they shall be treated for purposes of section 873(a) or section 882(c)(1) as connected with income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation. An election under this section does not cause a nonresident alien individual or foreign corporation, which is not engaged in trade or business in the United States during the taxable year, to be treated as though such taxpayer were engaged in trade or business in the United States during the taxable year. Thus, for example, the compensation received during the taxable year for services performed in the United States in a previous taxable year by a nonresident alien individual, who has an election in effect for the taxable year under this section but is engaged in trade or business in the United States at no time during the taxable year, is not effectively connected for the taxable year with the conduct of a trade or business in the United States. In further illustration, gain for the taxable year from the casual sale of personal property described in section 1221(I) derived by a nonresident alien individual who is not engaged in trade or business in the United States during the taxable year but has an election in effect for such year under this section is not effectively connected with the conduct of a trade or business in the United States. See § 1.864-3. If an election under this section is in effect for the taxable year, the income to which the election applies shall be treated, for purposes of section 871(b)(1) or section 882(a)(1), section 1441(c)(1), and paragraph (a) of § 1.1441-4, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the taxpayer.

(2) *Treatment of property to which election applies.* Any real property, or interest in real property, with respect to which an election under this section applies shall be treated as a capital asset which, if depreciable, is subject to the allowance for depreciation provided in section 167 and the regulations thereunder. Such property, or interest in property, shall be treated as property not used in a trade or business for purposes of applying any provisions of the Code, such as section 172(d)(4)(A), relating to gain or loss attributable to a trade or business for purposes of determining a net operating loss; section 1221(2), relating to property not constituting a capital asset; or section 1231(b), relating to special rules for treatment of gains and losses. For example, if a nonresident alien individual makes the election under this section and, while the election is in effect, sells unimproved land which is located in the United States and held for investment purposes, any gain or loss from the sale shall be considered gain or loss from the sale of a capital asset and shall be treated, for purposes of determining the tax under section 871(b)(1) and paragraph (b)(2) of § 1.871-8, as a gain or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(d) *Manner of making or revoking an election*—(1) *Election, or revocation, without consent of Commissioner*—(i) *In general.* A nonresident alien individual or foreign corporation may, for the first taxable year for which the election under this section is to apply, make the initial election at any time before the expiration of the period prescribed by section 6511(a), or by section 6511(c) if the period for assessment is extended by agreement, for filing a claim for credit or refund of the tax imposed by chapter 1 of the Code for such taxable year. This election may be made without the consent of the Commissioner. Having made the initial election, the taxpayer may, within the time prescribed for making the election for such taxable year, revoke the election without the consent of the Commissioner. If the revocation is timely and properly made, the taxpayer may make his initial election under this section for a later taxable year without the consent of the Commissioner. If the taxpayer revokes the initial election without the consent of the Commissioner he must file amended income tax returns, or claims for credit or refund, where applicable, for the taxable years to which the revocation applies.

(ii) *Statement to be filed with return.* An election made under this section without the consent of the Commissioner shall be made for a taxable year by filing with the income tax return required under section 6012 and the regulations thereunder for such taxable year a statement to the effect that the election is being made. This statement shall include (*a*) a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, (*b*) an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, (*c*) the location of the real property or interest therein, (*d*) a description of any substantial improvements on any such property, and (*e*) an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred. This statement may not be filed with any return under section 6851 and the regulations thereunder.

(iii) *Exemption from withholding of tax.* For statement to be filed with a withholding agent at the beginning of a taxable year in respect of which an election under this section is to be made, see paragraph (a) of § 1.1441-4.

(2) *Revocation, or election, with consent of Commissioner*—(i) *In general.* If the nonresident alien individual or foreign corporation makes the initial election under this section for any taxable year and the period prescribed by subparagraph (1)(i) of this paragraph for making the election for such taxable year has expired, the election shall remain in effect for all subsequent taxable years, including taxable years for which the taxpayer realizes no income from real property, or from any interest therein, or for which he is not required under section 6012 and the regulations thereunder to file an income tax return. However, the election may be revoked in accordance with subdivision (iii) of this subparagraph for any subsequent taxable year with the consent of the Commissioner. If the election for any such taxable year is revoked with the consent of the Commissioner, the taxpayer may not make a new election before his fifth taxable year which begins after the first taxable year for which the revocation is effective unless consent is given to such new election by the Commissioner in accordance with subdivision (iii) of this subparagraph.

(ii) *Effect of new election.* A new election made for the fifth taxable year, or taxable year thereafter, without the consent of the Commissioner, and a new election made with the consent of the Commissioner, shall be treated as an initial election to which subparagraph (1) of this paragraph applies.

(iii) *Written request required.* A request to revoke an election made under this section when such revocation requires the consent of the Commissioner, or to make a new election when such election requires the consent of the Commissioner, shall be made in writing and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225. The request shall include the name and address of the taxpayer and shall be signed by the taxpayer or his duly authorized representative. It must specify the taxable year for which the revocation or new election is to be effective and shall be filed within 75 days after the close of the first taxable year for which it is desired to make the change. The request must specify the grounds which are considered to justify the revocation or new election. The Director of International Operations may require such other information as may be necessary in order to determine whether the proposed change will be permitted. A copy of the consent by the Director of International Operations shall be attached to the taxpayer's return required under section 6012 and the regulations thereunder for the taxable year for which the revocation or new election is effective. A copy of such consent may not be filed with any return under section 6851 and the regulations thereunder.

(3) *Election by partnership.* If a nonresident alien individual or foreign corporation is a member of a partnership which has income described in paragraph (b)(1) of this section from real property, any election to be made under this section in respect of such income shall be made by the partners and not by the partnership.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44222, Dec. 23, 1974]

§ 1.871-11 Gains from sale or exchange of patents, copyrights, or similar property.

(a) *Contingent payment defined.* For purposes of section 871(a)(1)(D), section 881(a)(4), § 1.871-7(c)(1)(iv), § 1.881-2(c)(1)(iii), and this section, payments which are contingent on the productivity, use, or disposition of property or of an interest therein include continuing payments measured by a percentage of the selling price of the products marketed, or based on the number of units manufactured or sold, or based in a similar manner upon production, sale or use, or disposition of the property or interest transferred. A payment which is certain as to the amount to be received, but contingent as to the time of payment, or an installment payment of a principal sum agreed upon in a transfer agreement, shall not be treated as a contingent payment for purposes of this paragraph. For the inapplication of section 1253 to certain amounts described in this paragraph, see paragraph (a) of § 1.1253-1.

(b) *Payments treated as contingent on use.* Pursuant to section 871(e), if more than 50 percent of the gain of a nonresident alien individual or foreign corporation for any taxable year from the sale or exchange after October 4, 1966, of any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property, or of any interest in any such property, is from payments which are contingent on the productivity, use, or disposition of such property or interest, all of the gain of such individual or corporation for the taxable year from the sale or exchange of such property or interest are, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), or section 1442(a), and the regulations thereunder, to be treated as being from payments which are contingent on the productivity, use, or disposition of such property or interest. This paragraph does not apply for purposes of determining under section 871(b)(1) or 882(a)(1) the tax of a nonresident alien individual or foreign corporation on income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(c) *Sale or exchange.* A sale or exchange for purposes of this section includes, but is not limited to, a transfer by an individual which by reason of section 1235, relating to the sale or exchange of patents, is considered the sale or exchange of a capital asset. The provisions of section 1253, relating to transfers of franchises, trademarks, and trade names, do not apply in determining whether a transfer is a sale or exchange for purposes of this section.

(d) *Recovery of adjusted basis.* For purposes of determining for any taxable year the amount of gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4), payments received by the nonresident alien individual or foreign corporation during such year must be reduced by amounts representing recovery of the taxpayer's adjusted basis of the property or interest which is sold or exchanged. Where the taxpayer receives in the same taxable year payments which, without reference to section 871(e) and this section, are not contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged and payments which are contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged, the taxpayer's unrecovered adjusted basis in the property or interest which is sold or exchanged must be allocated for the taxable year between such payments on the basis of the gross amount of each such type of payments. Where the taxpayer receives in the taxable year only payments which are not so contingent or only payments which are so contingent, the taxpayer's unrecovered basis must be allocated in its entirety to such payments for the taxable year.

(e) *Source rule.* In determining whether gains described in section 871(a)(1)(D) or 881(a)(4) and paragraph (b) of this section are received from sources within the United States, such gains shall be treated, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), and section 1442(a), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See section 861(a)(4), § 1.861-5, and paragraph (a) of § 1.862-1.

(f) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). (a) A, a nonresident alien individual who uses the cash receipts and disbursements method of accounting and the calendar year as the taxable year, holds a U.S. patent which he developed through his own effort. On December 15, 1967, A enters into an agreement of sale with M Corporation, a domestic corporation, whereby A assigns to M Corporation all of his U.S. rights in the patent. In consideration of the sale, M Corporation is obligated to pay a fixed sum of $60,000, $20,000 being payable on execution of the contract and the balance payable in four annual installments of $10,000 each. As additional consideration, M Corporation agrees to pay to A a royalty in the amount of 2 percent of the gross sales of the products manufactured by M Corporation under the patent. A is not engaged in trade or business in the United States at any time during 1967 and 1968. His adjusted basis in the patent at the time of sale is $28,800.

(b) In 1967, A receives only the $20,000 paid by M Corporation on the execution of the contract of sale. No gain is realized by A upon receipt of this amount, and his unrecovered adjusted basis in the patent is reduced to $8,800 ($28,800 less $20,000).

(c) In 1968, M Corporation has gross sales of $600,000 from products manufactured under the patent. Consequently, for 1968, M Corporation pays $22,000 to A, $10,000 being the annual installment on the fixed payment and $12,000 being payments under the terms of the royalty provision. A's recognized gain for 1968 is $13,200 ($22,000 reduced by the unrecovered adjusted basis of $8,800). Of the total gain of $13,200, gain in the amount of $6,000 ($10,000 − [$8,800 × $10,000/$22,000]) is considered to be from the fixed installment payment and of $7,200 ($12,000 − [$8,800 × $12,000/$22,000]) is considered to be from the royalty payment. Since 54.5 percent ($7,200/$13,200) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, all of the $13,200 gain recognized in 1968 is treated, for purposes of section 871(a)(1)(D) and section 1441(b), as being from payments which are contingent on the productivity, use, or disposition of the patent.

Example (2). (a) F, a foreign corporation using the calendar year as the taxable year and not engaged in trade or business in the United States, holds a U.S. patent on certain property which it developed through its own efforts. Corporation F uses the cash receipts and disbursements method of accounting. On December 1, 1966, F Corporation enters into an agreement of sale with D Corporation, a domestic corporation, whereby D Corporation purchases the exclusive right and license, and the right to sublicense to others, to manufacture, use, and/or sell certain devices under the patent in the United States during the term of the patent. The agreement grants D Corporation the right to dispose, anywhere in the world, of machinery manufactured in the United States and equipped with such devices. Corporation D is granted the right, at its own expense, to prosecute infringers in its own name or in the name of F Corporation, or both, and to retain any damages recovered.

(b) Corporation D agrees to pay to F Corporation annually $5 for each device manufactured under the patent during the year but in no case less than $5,000 per year. In 1967, D Corporation manufactures 2,500 devices under the patent; and, in 1968, 1,500 devices. Under the terms of the contract D Corporation pays to F Corporation in 1967 $12,500 with respect to production in that year and $7,500 in 1968 with respect to production in that year. F Corporation's basis in the patent at the time of the sale is $17,000.

(c) With respect to the payments received by F Corporation in 1967, no gain is realized by that corporation and its unrecovered adjusted basis in the patent is reduced to $4,500 ($17,000 less $12,500).

(d) With respect to the payments received by F Corporation in 1968, such corporation has recognized gain of $3,000 ($7,500 reduced by unrecovered adjusted basis of $4,500). Of the total gain of $3,000, gain in the amount of $2,000 ($5,000 − [$4,500 × $5,000/$7,500]) is considered to be from the fixed installment payment and of

$1,000 ($2,500 - [$4,500 × $2,500/$7,500]) is considered to be from payments which are contingent on the productivity, use, or disposition of the patent. Since 33.3 percent ($1,000/$3,000) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, only $1,000 of the $3,000 gain for that year constitutes gains which, for purposes of section 881(a)(4) and section 1442(a), are from payments which are contingent on the productivity, use, or disposition of the patent. The balance of $2,000 is gain from the sale of property and is not subject to tax under section 881(a).

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966, but only in respect of gains from sales or exchanges occurring after October 4, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44224, Dec. 23, 1974]

§ 1.871-12 Determination of tax on treaty income.

(a) *In general.* This section applies for purposes of determining under § 1.871-7 or § 1.871-8 the tax of a nonresident alien individual, or under § 1.881-2 or § 1.882-1 the tax of a foreign corporation, which for the taxable year has income described in section 872(a) or 882(b) upon which the tax is limited by an income tax convention to which the United States is a party. Income for such purposes does not include income of any kind which is exempt from tax under the provisions of an income tax convention to which the United States is a party. See §§ 1.872- 2(c) and 1.883-1(b). This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year.

(b) *Definition of treaty and nontreaty income*—(1) *In general.* (i) For purposes of this section the term "treaty income" shall be construed to mean the gross income of a nonresident alien individual or foreign corporation, as the case may be, the tax on which is limited by a tax convention. The term "non-treaty income" shall be construed, for such purposes, to mean the gross income of the nonresident alien individual or foreign corporation other than the treaty income. Neither term includes income of any kind which is exempt from the tax imposed by chapter 1 of the Code.

(ii) In determining either the treaty or nontreaty income the gross income shall be determined in accordance with §§ 1.872-1 and 1.872-2, or with §§ 1.882-3 and 1.883-1, except that in determining the treaty income the exclusion granted by section 116(a) for dividends shall not be taken into account. Thus, for example, treaty income includes the total amount of dividends paid by a domestic corporation not disqualified by section 116(b) and received from sources within the United States if, in accordance with a tax convention, the dividends are subject to the income tax at a rate not to exceed 15 percent but does not include interest which, in accordance with a tax convention, is exempt from the income tax. In further illustration, neither the treaty nor the nontreaty income includes interest on certain governmental obligations which by reason of section 103 is excluded from gross income, or interest which by reason of a tax convention is exempt from the tax imposed by chapter 1 of the Code.

(iii) For purposes of applying any income tax convention to which the United States is a party, original issue discount which is subject to tax under section 871(a)(1)(C) or 881(a)(3) is to be treated as interest, and gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4) are to be treated as royalty income. This subdivision shall not apply, however, where its application would be contrary to any treaty obligation of the United States.

(2) *Application of permanent establishment rule of treaties.* In applying this section with respect to income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or foreign corporation, see section 894(b), which provides that with respect to such income the nonresident alien individual or foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year for

purposes of applying any exemption from, or reduction in rate of, tax provided by any tax convention.

(c) *Determination of tax*—(1) *In general.* If the gross income of a nonresident alien individual or foreign corporation, as the case may be, consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subparagraphs (2) and (3) of this paragraph. In no case, however, may the tax liability so determined exceed the tax liability (tax reduced by allowable credits) with respect to the taxpayer's entire income, determined in accordance with § 1.871-7 or § 1.871-8, or with § 1.881-2 or § 1.882-1, as though the tax convention had not come into effect and without reference to the provisions of this section. Determinations under this paragraph shall be made without taking into account any credits allowed by sections 31, 32, 39, and 6402, but such credits shall be allowed against the tax liability determined in accordance with this subparagraph.

(2) *Tax on nontreaty income.* For purposes of subparagraph (1) of this paragraph, compute a partial tax (determined without the allowance of any credit) upon only the nontreaty income in accordance with § 1.871-7 or § 1.871-8, or with § 1.881-2 or § 1.882-1, whichever applies, as though the tax convention had not come into effect. To the extent allowed by paragraph (d) of § 1.871-8, or paragraph (c) of § 1.882-1, the credits allowed by sections 33, 35, 38, and 40 shall then be allowed, without taking into account any item included in the treaty income, against the tax determined under this subparagraph.

(3) *Tax on treaty income.* For purposes of subparagraph (1) of this paragraph, compute a tax upon the gross amount, determined without the allowance of any deduction, of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. No credits shall be allowed against the tax determined under this subparagraph.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). (a) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1967 from sources within the United States total gross income of $4,100, consisting of the following items and determined without regard to the $100 exclusion granted by section 116(a):

Dividends the tax on which is limited by the tax convention to a rate not to exceed 15 percent	$3,100
Compensation for personal services, the tax on which is not limited by the tax convention	1,000
Total gross income	4,100

(b) The dividends are paid by a domestic corporation not disqualified by section 116(b). The taxpayer is engaged in business in the United States during the taxable year by reason of performing personal services in the United States for a period in excess of 90 days, but does not have a permanent establishment therein. Under paragraph (c)(6)(i) of § 1.864-4, the dividends are effectively connected for the taxable year with the conduct of a trade or business in the United States. Interest expense in the amount of $2,100 connected with the dividend income is paid by the taxpayer during the taxable year.

(c) The tax liability for the taxable year is $193, determined as follows:

Total gross income, determined by taking into account the exclusion granted by section 116(a)		$4,000
Less: Deduction for interest expense paid	$2,100	
Deduction for personal exemption	600	2,700
Taxable income		1,300
Tax under section 1 of the Code (determined as provided in § 1.871-8(b)(2) as though the tax convention had not come into effect) ($145 plus 16 percent of $300)		193

(d) If the tax had been determined as provided in paragraph (c) (2) and (3) of this section, the tax liability would have been $521, determined as follows:

Nontreaty gross income	$1,000
Less: Deduction for personal exemption	600
Nontreaty taxable income	400

Tax under section 1 of the Code on nontreaty taxable income (14% of $400)	56
Plus: Tax on treaty income (gross dividends) ($3,100 × 15 percent)	465
Total tax	521

Example (2). (a) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1967 from sources within the United States total gross income of $22,000, consisting of the following items:

Compensation for personal services the tax on which is not limited by the tax convention (effectively connected income under § 1.864-4(c)(6)(ii))	$20,000
Oil royalties the tax on which is limited by the tax convention to 15 percent of the gross amount thereof (effectively connected income by reason of election under § 1.871-10)	2,000
Total gross income	22,000

(b) The taxpayer is engaged in business in the United States during the taxable year but does not have a permanent establishment therein. There are no allowable deductions, other than the deductions allowed by sections 613 and 873(b)(3).

(c) The tax liability for the taxable year is $6,100, determined as follows:

Nontreaty gross income	$20,000
Less: Deduction for personal exemption	600
Nontreaty taxable income	19,400
Tax under section 1 of the Code on nontreaty taxable income ($5,170 plus 45 percent of $1,400)	5,800
Plus: Tax on treaty income (Gross oil royalties) ($2,000 × 15 percent)	300
Total tax (determined as provided in paragraph (c) (2) and (3) of this section)	6,100

(d) If the tax had been determined under paragraph (b)(2) of § 1.871-8 as though the tax liability would have been $6,478, determined as follows and by taking into account the election under § 1.871-10:

Total gross income		$22,000
Less: Deduction under section 613 for percentage depletion ($2000 × 27½ percent)	$550	
Deduction for personal exemption	600	1,150
Taxable income	20,850	
Tax under section 1 of the Code on taxable income ($6,070 plus 48 percent of $850)		6,478

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.871-7(e) (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44225, Dec. 23, 1974]

§ 1.871-13 Taxation of individuals for taxable year of change of U.S. citizenship or residence.

(a) *In general.* (1) An individual who is a citizen or resident of the United States at the beginning of the taxable year but a nonresident alien at the end of the taxable year, or a nonresident alien at the beginning of the taxable year but a citizen or resident of the United States at the end of the taxable year, is taxable for such year as though his taxable year were comprised of two separate periods, one consisting of the time during which he is a citizen or resident of the United States and the other consisting of the time during which he is not a citizen or resident of the United States. Thus, for example, the income tax liability of an alien individual under chapter 1 of the Code for the taxable year in which he changes his residence will be computed under two different sets of rules, one relating to resident aliens for the period of residence and the other relating to nonresident aliens for the period of nonresidence. However, in determining the taxable income for such year which is subject to the graduated rate of tax imposed by section 1 or 1201 of the Code, all income for the period of U.S. citizenship or residence must be aggregated with the income for the period of nonresidence which is effectively connected for such year with the conduct of a trade or business in the United States. This section does not apply to alien individuals treated as residents for the entire taxable year under section 6013 (g) or (h). These individuals are taxed under the rules in § 1.1-1(b).

(2) For purposes of this section, an individual is deemed to be a citizen or resident of the United States for the day on which he becomes a citizen or resident of the United States, a nonresident of the United States for the day on which he abandons his U.S. residence, and an alien for the day on which he gives up his U.S. citizenship.

(b) *Acquisition of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received by an alien individual while he is not a resident of the United States even though he becomes a citizen or resident of the United States after its receipt and before the close of the taxable year. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received by an individual while he is a citizen or resident of the United States, even though he earns the income earlier in the taxable year while he is neither a citizen nor resident of the United States.

(c) *Abandonment of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received by an alien individual while he is not a resident of the United States, even though he earns the income earlier in the taxable year while he is a citizen or resident of the United States. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received by an individual while he is a citizen or resident of the United States, even though he abandons his U.S. citizenship or residence after its receipt and before the close of the taxable year.

(d) *Special rules*—(1) *Method of accounting.* Paragraphs (b) and (c) of this section may not apply to an individual who for the taxable year uses an accrual method of accounting.

(2) *Deductions for personal exemptions.* An alien individual to whom this section applies is entitled to deduct one personal exemption for the taxable year under section 151. In addition, he is entitled to such additional exemptions as are allowed as a deduction under section 151 but only to the extent the amount of such additional exemptions do not exceed his taxable income (determined without regard to any deduction for personal exemptions) for the period in the taxable year during which he is a citizen or resident of the United States. This subparagraph does not apply to the extent it is inconsistent with section 873, and the regulations thereunder, or with the provisions of an income tax convention to which the United States is a party.

(3) *Exclusion of dividends received.* In determining the $100 exclusion for the taxable year provided by section 116 in respect of certain dividends, only those dividends for the period during which the individual is neither a citizen nor resident of the United States may be taken into account as are effectively connected for the taxable year with the conduct of a trade or business in the United States. See § 1.116-1(e)(1).

(e) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). A, a married alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, becomes a resident of the United States on June 1, 1971. During the period of nonresidence from January 1, 1971, to May 31, 1971, inclusive, A receives $15,000 income from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States. During the period of residence from June 1, 1971, to December 31, 1971, A receives wages of $10,000, dividends of $200 from a foreign corporation, and dividends of $75 from a domestic corporation qualifying under section 116(a). Of the amount of wages so received, $2,000 is for services performed by A outside the United States during the period of nonresidence. Total allowable deductions (other than for personal exemptions) amount to $700, none of which are deductible under section 62 in computing adjusted gross income. For 1971 A's spouse has no gross income and is not the dependent of another taxpayer. For 1971, A's taxable income is $8,200, all of which is subject to tax under section 1, as follows:

Wages		$10,000
Dividends from foreign corporation		200
Dividends from domestic corporation ($75 less $75 exclusion)		0
Adjusted gross income		10,200
Less deductions:		
Personal exemptions (2 × $650)	$1,300	
Other allowable deductions	700	2,000
Taxable income		8,200

Example (2). The facts are the same as in example (1) except that during the period of nonresidence from January 1, 1971, to May 31, 1971, A receives from sources within the United States income of $1,850 which is effectively connected with the conduct by A of a business in the United States and $350 in dividends from domestic corporations qualifying under section 116(a). Only $50 of these dividends are effectively connected with the conduct by A of a business in the United States. The assumption is made that there are no allowable deductions connected with such effectively connected income. For 1971, A has taxable income of $10,075 subject to tax under section 1 and $300 income subject to tax under section 871(a)(1)(A), as follows:

Wages		$10,000
Business income		1,850
Dividends from foreign corporation		200
Dividends from domestic corporation ($125 less $100 exclusion)		25
Adjusted gross income		12,075
Less deductions:		
Personal exemptions (2 × $650)	$1,300	
Other allowable deductions	700	2,000
Taxable income subject to tax under section 1		10,075
Income subject to tax under section 871(a)(1)(A)		300

Example (3). A, a married alien individual with three children, uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. On October 1, 1971, A and his family become residents of the United States. During the period of nonresidence from January 1, 1971, to September 30, 1971, A receives income of $18,000 from sources without the United States which is not effectively connected with the conduct of a trade or business in the United States and of $2,500 from sources within the United States which is effectively connected with the conduct of a business in the United States. It is assumed there are no allowable deductions connected with such effectively connected income. During the period of residence from October 1, 1971, to December 31, 1971, A receives wages of $2,000, of which $400 is for services performed outside the United States during the period of nonresidence. Total allowable deductions (other than for personal exemptions) amount to $250, none of which are deductible under section 62 in computing adjusted gross income. Neither the spouse nor any of the children has any gross income for 1971, and the spouse is not the dependent of another taxpayer for such year. For 1971, A's taxable income is $1,850, all of which is subject to tax under section 1, as follows:

Wages (residence period)	$2,000	
Less: Allowable deductions	250	
Taxable income (without deduction for personal exemptions) (residence period)		$1,750
Business income (nonresidence period)		2,500
Total taxable income (without deduction for personal exemptions)		4,250
Less deduction for personal exemptions:		
Taxpayer	650	
Wife and 3 children (4 × $650, but not to exceed $1,750)	1,750	2,400
Taxable income		1,850

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44226, Dec. 23, 1974, as amended by T.D. 7670, 45 FR 6928, Jan. 31, 1980.]

§ 1.872-1 Gross income of nonresident alien individuals.

(a) *In general*—(1) *Inclusions.* The gross income of a nonresident alien individual for any taxable year includes only (i) the gross income which is derived from sources within the United States and which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual and (ii) the gross income, irrespective of whether such income is derived from sources within or without the United States, which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. For the determination of the sources of income, see sections 861 through 863 and the regulations thereunder. For the determination of whether income from sources within or without the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States, see sections 864(c) and 871 (c) and (d), §§ 1.864-3 through 1.864-7, and §§ 1.871-9 and 1.871-10. For special rules for determining the income of an alien individual who changes his residence during the taxable year, see § 1.871-13.

(2) *Exchange transactions.* Even though a nonresident alien individual who effects certain transactions in the United States in stocks, securities, or commodities during the taxable year may not, by reason of section 864(b)(2) and paragraph (c) or (d) of § 1.864-2, be engaged in trade or business in the United States during the taxable year through the effecting of such transactions, nevertheless he shall be required to include in gross income for the taxable year the gains and profits from those transactions to the extent required by § 1.871-7 or § 1.871-8.

(3) *Exclusions.* For exclusions from gross income, see § 1.872-2.

(b) *Individuals not engaged in U.S. business.* In the case of a nonresident alien individual who at no time during the taxable year is engaged in trade or business in the United States, the gross income shall include only (1) the gross income from sources within the United States which is described in section 871(a) and paragraphs (b), (c), and (d) of § 1.871-7, and (2) the gross income from sources within the United States which, by reason of section 871 (c) or (d) and § 1.871-9 or § 1.871-10, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

(c) *Individuals engaged in U.S. business.* In the case of a nonresident alien individual who is engaged in trade or business in the United States at any time during the taxable year, the gross income shall include (1) the gross income from sources within and without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, (2) the gross income from sources within the United States which, by reason of the election provided in section 871(d) and § 1.871-10, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual, and (3) the gross income from sources within the United States which is described in section 871(a) and paragraphs (b), (c), and (d) of § 1.871-7 and is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

(d) *Special rules applicable to certain expatriates.* For special rules for determining the gross income of a nonresident alien individual who has lost U.S. citizenship with a principal purpose of avoiding certain taxes, see section 877(b)(1).

(e) *Alien resident of Puerto Rico.* This section shall not apply in the case of a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See section 876 and § 1.876-1.

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.872-1 (Rev. as of Jan. 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7332, 39 FR 44228, Dec. 23, 1974]

§ 1.872-2 Exclusions from gross income of nonresident alien individuals.

(a) *Earnings of foreign ships or aircraft*—(1) *Basic rule.* So much of the income from sources within the United States of a nonresident alien individual as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*—(i) *Ships.* A foreign country which either im-

poses no income tax, or, in imposing an income tax, exempts from taxation so much of the income of a citizen of the U.S. nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing an income tax, exempts from taxation so much of the income of a citizen of the U.S. nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(3) *Definition of earnings.* For purposes of subparagraphs (1) and (2) of this paragraph, compensation for personal services performed by an individual aboard a ship or aircraft does not constitute earnings derived by such individual from the operation of ships or aircraft.

(b) *Compensation paid by foreign employer to participants in certain exchange or training programs*—(1) *Exclusion from income.* Compensation paid to a nonresident alien individual for the period that the nonresident alien individual is temporarily present in the United States as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)) shall be excluded from gross income if the compensation is paid to such alien by his foreign employer. Compensation paid to a nonresident alien individual by the U.S. office of a domestic bank which is acting as paymaster on behalf of a foreign employer constitutes compensation paid by a foreign employer for purposes of this paragraph if the domestic bank is reimbursed by the foreign employer for such payment. A nonresident alien individual who is temporarily present in the United States as a nonimmigrant under such subparagraph (J) includes a nonresident alien individual admitted to the United States as an "exchange visitor" under section 201 of the U.S. Information and Educational Exchange Act of 1948 (22 U.S.C. 1446), which section was repealed by section 111 of the Mutual Education and Cultural Exchange Act of 1961 (75 Stat. 538).

(2) *Definition of foreign employer.* For purposes of this paragraph, the term "foreign employer" means a nonresident alien individual, a foreign partnership, a foreign corporation, or an office or place of business maintained in a foreign country or in a possession of the United States by a domestic corporation, a domestic partnership, or an individual who is a citizen or resident of the United States. The term does not include a foreign government. However, see section 893 and § 1.893-1. Thus, if a French citizen employed in the Paris branch of a banking company incorporated in the State of New York were admitted to the United States under section 101(a)(15)(J) of the Immigration and Nationality Act to study monetary theory and continued to receive a salary from such foreign branch while studying in the United States, such salary would not be includable in his gross income.

(c) *Tax convention.* Income of any kind which is exempt from tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the gross income of a nonresident alien individual. Income on which the tax is limited by tax convention shall be included in the gross income of a nonresident alien individual if it is not otherwise excluded from gross income. See §§ 1.871-12 and 1.894-1.

(d) *Certain bond income of residents of the Ryukyu Islands or the Trust Territory of the Pacific Islands.* Income derived by a nonresident alien individual from a series E or series H U.S. savings bond shall not be included in gross income if such individual acquired the bond while he was a resident of the Ryukyu Islands or the Trust Territory of the Pacific Islands. It is not necessary that the individual continue to be a resident of such Islands or Trust Territory for the period when, without regard to section 872(b)(4) and this paragraph, the income from the bond would otherwise be includible in his gross income under the provisions of section 446 or 454.

(e) *Certain annuities received under qualified plans.* Pursuant to section 871(f), income received by a nonresident alien individual as an annuity under a qualified annuity plan described in section 403(a)(1) (relating to taxation of employee annuities), or from a qualified trust described in section 401(a) (relating to qualified pension, profit-sharing, and stock bonus plans) which is exempt from tax under section 501(a) (relating to exemption from tax on corporations, certain trusts, etc.), shall not be included in gross income, and shall be exempt from tax, for purposes of section 871 and §§ 1.871-7 and 1.871-8, if—

(1) All of the personal services by reason of which the annuity is payable were either—

(i) Personal services performed outside the United States by an individual (whether or not the annuitant) who, at the time of performance of the services, was a nonresident alien individual, or

(ii) Personal services performed in the United States by a nonresident alien individual (whether or not the annuitant) which, by reason of section 864(b)(1) (or corresponding provision of any prior law), were not personal services causing such individual to be engaged in trade or business in the United States during the taxable year, and

(2) At the time the first amount is paid (even though paid in a taxable year beginning before January 1, 1967) as such annuity under such annuity plan, or by such trust, to (i) the individual described in subparagraph (1) of this paragraph, or (ii) his nonresident alien beneficiary if such beneficiary is entitled to receive such first amount, 90 percent or more of the employees or annuitants for whom contributions or benefits are provided under the annuity plan, or under the plan or plans of which the trust is a part, are citizens or residents of the United States.

This paragraph shall apply whether or not the taxpayer is engaged in trade or business in the United States at any time during the taxable year in which the annuity is received. This paragraph shall not apply to distributions by an employees' trust or from an annuity plan which give rise to gains described in section 402(a)(2) or 403(a)(2), whichever applies. See section 871(a)(1)(B) and paragraph (c)(1)(i) of § 1.871-7. For exemption from withholding of tax at source on an annuity which is exempt from tax under section 871(f) and this paragraph, see paragraph (g) of § 1.1441-4.

(f) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of sections 861 through 863, and the regulations thereunder, is not included in the gross income of a nonresident alien individual unless such income is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code. For special rules under a tax convention for determining the sources of income and for excluding, from gross income, income from sources without the United States which is effectively connected with the conduct of a trade or business in the United States, see the applicable tax convention. For determining which income from sources without the United States is effectively connected with the conduct of a trade or business in the United States, see section 864(c)(4) and § 1.864-5.

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 4, 1967 see 26 CFR § 1.872-2 (Rev. as of Jan. 1, 1971).

[T.D. 7332, 39 FR 44228, Dec. 23, 1974]

§ 1.873-1 Deductions allowed nonresident alien individuals.

(a) *General provisions*—(1) *Allocation of deductions.* In computing the taxable income of a nonresident alien individual the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. No deduction shall be allowed in respect of any item, or portion thereof, which is not connected with income from such sources. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, except as may otherwise be provided by tax convention. Thus, from the items of gross income specifically from sources within the United States and from the items allocated thereto under the provisions of section 863(a), there shall be deducted (i) the expenses, losses, and other deductions which are connected with those items of income and are properly apportioned or allocated thereto, and (ii) a ratable part of any other expenses, losses, or deductions which are connected with those items of income but cannot definitely be allocated to some item or class of gross income. The ratable part shall be based upon the ratio of gross income from sources within the United States to the total gross income. See §§ 1.861-8 and 1.863-1. In the case of income partly from within and partly from without the United States the expenses, losses, and other deductions connected with income from sources within the United States shall also be deducted in the manner prescribed by §§ 1.863-2 through 1.863-5 in order to ascertain under section 863 the portion of the taxable income attributable to sources within the United States.

(2) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151 or 642(b) shall not be taken into account for purposes of subparagraph (1) of this paragraph but shall be allowed to the extent provided by paragraphs (b) and (c) of this section.

(3) *Adjusted gross income.* The adjusted gross income of a nonresident alien individual shall be the gross income from sources within the United States, determined in accordance with § 1.871-7, minus the deductions prescribed by section 62 to the extent such deductions are allowed under this section in computing taxable income.

(4) *Standard deduction.* The standard deduction shall not be allowed in computing the taxable income of a nonresident alien individual. See section 142(b)(1) and the regulations thereunder.

(5) *Exempt income.* No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(b) *No United States business*—(1) *Income of not more than $15,400*—(i) *Deduction for losses only.* A nonresident alien individual within class 1 shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b)(4)(vii) of § 1.871-7. Thus, an individual within this class shall not be allowed any deductions for the personal exemptions otherwise allowed by section 151 or 642(b).

(ii) *Source of losses.* Notwithstanding the provisions of section 873(b)(1), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (b)(4)(i) of § 1.871-7.

(2) *Aggregate more than $15,400*—(i) *Deductions allowed.* In computing the income subject to tax under section 1 or section 1201(b), a nonresident alien individual within class 2 shall be allowed deductions to the extent prescribed by paragraph (c)(3) of § 1.871-7, but subject to the limitations of this section. For this purpose, the deduction for the personal exemptions shall be allowed in accordance with subdivision (iii) of this subparagraph.

(ii) *Deductions disallowed.* In computing the minimum tax prescribed by section 871(b)(3), that individual shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b)(4)(vii) of § 1.871-7. For this purpose, the deductions for the personal exemptions shall not be allowed. See paragraph (c)(4) of § 1.871-7.

(iii) *Personal exemptions.* When the deductions for personal exemptions are allowed under this subparagraph, only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

(iv) *Source of losses.* Notwithstanding the provisions of section 873(b), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (c)(3)(i) of § 1.871-7.

(3) *Election to be taxed on a net basis.* Notwithstanding the other provisions of this paragraph, a nonresident alien individual within class 1 or 2 shall be allowed the deductions allowed by paragraph (c) of this section, if pursuant to a tax convention he is entitled, and does elect, to be subject to United States tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein.

(c) *United States business*—(1) *Deductions in general.* For purposes of computing the income subject to tax, a nonresident alien individual within class 3 shall be allowed deductions to the extent prescribed by paragraph (d) of § 1.871-7, but subject to the limitations of this section. For this purpose, the deductions for the personal exemptions shall be allowed in accordance with subparagraph (3) of this paragraph.

(2) *Special deductions.* Notwithstanding the rule of source prescribed in paragraph (a) of this section, an individual within class 3 shall be allowed the following deductions whether or not they are connected with income from sources within the United States:

(i) *Losses on transactions for profit.* Any loss sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with a trade or business, shall be allowed to the extent allowed by section 165(c)(2), but only if and to the extent that the profit, if the transaction had resulted in a profit, would be taxable to such individual. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861-8 and 1.863-1, when the profit from the transaction, if it had resulted in a profit, would, under the provisions of section 861(a) or 863(a), have been taxable in full as income from sources within the United States; but shall be deducted under the provisions of § 1.863-3 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

(ii) *Casualty losses.* Any loss of property not connected with a trade or business, sustained during the taxable year and not compensated for by insurance or otherwise, if the loss arises from fire, storm, shipwreck, or other casualty, or from theft, shall be allowed to the extent allowed by section 165(c)(3), but only if the loss is of property within the United States. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861-8 and 1.863-1, from the items of gross income specified under sections 861(a) and 863(a) as being derived in full from sources within the United States; but, if greater than the sum of those items, the unabsorbed loss shall be deducted from the income apportioned under the provisions of § 1.863-3 to sources within the United States.

(iii) *Charitable contributions.* The deduction for charitable contributions and gifts, to the extent allowed by section 170, shall be allowed under this subparagraph, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(3) *Personal exemptions.* Only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642(b) and the regulations thereunder.

§ 1.874-1 Allowances of deductions and credits to nonresident alien individuals.

(a) *Return required.* A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him with respect to the income tax, only if he files or causes to be filed with the district director (or, if applicable, with the Director of International Operations), in accordance with section 6012 and the regulations thereunder, a true and accurate return of his total income received from all sources within the United States. This paragraph shall not be construed, however, to deny the credits provided by sections 31 and 32.

(b) *Tax on gross income.* If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with § 1.871-7 but without regard to any deductions otherwise allowable, and the only credits allowable against the tax so computed shall be those allowed by sections 31 and 32. This paragraph shall apply even though the tax determined in accordance with § 1.871-7 has been fully satisfied at the source. See also § 1.872-1. Notwithstanding the requirement that a nonresident alien must file a return in order to receive the benefit of the deductions and credits allowed to him with respect to the income tax, he may, for purposes of determining the amount of tax to be withheld under section 1441 from remuneration paid for labor or personal services performed by him within the United States, receive the benefit of the deduction for personal exemptions provided in section 151, to the extent allowable under section 873(d) and paragraph (c)(3) of § 1.873-1, by filing a claim therefor with the withholding agent. The amount of the deduction for such personal exemptions and the amount of the tax to be withheld under such circumstances shall be determined in accordance with paragraph (e)(2) of § 1.1441-3.

(c) *Return by district director.* If a nonresident alien individual has various sources of income within the United States, so that from any one source, or from all sources combined, the amount of income shall call for the assessment of a tax greater than that withheld at the source in the case of that individual, and a return of income has not been filed by him or on his behalf, the district director (or, if applicable, the Director of International Operations) shall (1) cause a return of income to be made, (2) include therein the income described in § 1.871-7 of that individual from all sources concerning which he has information, and (3) assess the tax and collect it from one or more of those sources of income within the United States, without allowance for deductions or credits (other than the credits provided by sections 31 and 32).

(d) *Alien resident of Puerto Rico.* This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See § 1.876-1.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6669, 28 FR 9385, Aug. 27, 1963]

§ 1.875-1 Partnerships.

Whether a nonresident alien individual who is a member of a partnership is taxable in accordance with subsection (a), (b), or (c) of section 871 may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 871 (a) or (b), as the case may be, depending on whether or not he receives during the taxable year an aggregate of more than $15,400 gross income described in section 871(a), if he is not otherwise engaged in trade or business within the United States. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States is considered as being engaged in trade or business within the United States and is therefore taxable under section 871(c). For definition of what the term "partnership" includes, see section 7701(a)(2) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. See § 1.871-8.

§ 1.875-2 Beneficiaries of estates or trusts.

(a) [Reserved]

(b) *Exception for certain taxable years.* Notwithstanding paragraph (a) of this section, for any taxable year beginning before January 1, 1975, the grantor of a trust, whether revocable or irrevocable, is not deemed to be engaged in trade or business within the United States merely because the trustee is engaged in trade or business within the United States.

(c) [Reserved]

[T.D. 7332, 39 FR 44233, Dec. 23, 1974]

§ 1.876-1 Alien residents of Puerto Rico.

(a) *General.* A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in accordance with the provisions of section 876, subject to tax under section 1 or, in the alternative, under section 1201(b) in generally the same manner as in the case of an alien resident of the United States. See paragraph (b) of § 1.1-1 and § 1.871-1. The tax is imposed upon the taxable income of such a resident of Puerto Rico, determined in accordance with section 63(a) and the regulations thereunder, from sources both within and without the United States, except that under the provisions of section 933 income derived from sources within Puerto Rico (other than amounts received for services performed as an employee of the United States or any agency thereof) is excluded from gross income. For determining the form of return to be used by such an individual, see section 6012 and the regulations thereunder.

(b) *Exceptions.* Though subject to the tax imposed by section 1, a nonresident alien individual who is a bona fide resident of Puerto Rico during his entire taxable year shall nevertheless be treated as a nonresident alien individual for the purpose of many provisions of the Code relating to nonresident alien individuals. Thus, for example, such a resident of Puerto Rico is not allowed to determine his tax in accordance with the optional tax table (section 4(d)(1)); is not allowed the standard deduction (section 142(b)(1); is not allowed a deduction for a "dependent" who is a resident of Puerto Rico unless the dependent is a citizen of the United States (section 152 (b)(3)); is subject to withholding of tax at source under chapter 3 of the Code (sections 1441(e) and 1451(e)); is generally excepted from the collection of income tax at source on wages (paragraph (d)(1) of § 31.3401(a)(6)-1 of this chapter (Employment Tax Regulations)); is not allowed to make a joint return or a joint declaration of estimated tax (sections 6013(a)(1) and 6015(b)); must pay his estimated income tax on or before the 15th day of the 4th month of the taxable year (sections 6015(i)(3), 6073(a), and 6153(a)(1)); and generally must pay his income tax on or before the 15th day of the 6th month following the close of the taxable year (sections 6072(c) and 6151(a)).

(c) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to taxes of foreign countries), section 35 (relating to partially tax-exempt interest), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), and section 40 (relating to expenses of work incentive programs) shall be allowed against the tax determined in accordance with this section. No credit shall be allowed under section 37 in respect of retirement income.

(d) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.876-1 (Rev. as of Jan. 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17819, Dec. 16, 1964; T.D. 7332, 39 FR 44229, Dec. 23, 1974]

§ 1.879-1 Treatment of community income.

(a) *Treatment of community income*—(1) *In general.* For taxable years beginning after December 31, 1976, community income of a citizen or resident of the United States who is married to a nonresident alien individual, and the deductions properly allocable to that income, shall be divided between the U.S. citizen or resident spouse in accordance with the rules in section 879 and paragraph (a)(2) through (a)(6) of this section.This section does not apply for any taxable year with respect to which an election under section 6013 (g) or (h) is in effect. Community income for this purpose includes all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the State, foreign country, or possession of the United States in which the recipient of the income is domiciled. Income from real property also may be community income if so treated under the laws of the jurisdiction in which the real property is located.

(2) *Earned income.* Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services. This paragraph (a)(2) does not apply, however, to the following items of community income:

(i) Community income derived from any trade or business carried on by the husband or the wife.

(ii) Community income attributable to a spouse's distributive share of the income of a partnership to which paragraph (a)(4) of this section applies.

(iii) Community income consisting of compensation for personal services rendered to a corporation which represents a distribution of the earnings and profits of the corporation rather than a reasonable allowance as compensation for the personal services actually performed, but not including any income that would be treated as earned income under the second sentence of section 911(b).

(iv) Community income derived from property which is acquired as consideration for personal services performed.

These items of community income are divided in accordance with the rules in paragraph (a)(3) through (a)(6) of this section.

(3) *Trade or business income.* If any income derived from a trade or business carried on by the husband or wife is community income for the taxable year, all of the gross income, and the deductions attributable to that income, shall be treated as the gross income and deductions of the husband. However, if the wife exercises substantially all of the management and control of the trade or business, all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This paragraph (a)(3) does not apply to any income derived from a trade or business carried on by a partnership of which both or one of the spouses is a member (see paragraph (a)(4) of this section). For purposes of this paragraph (a)(3), income derived from a trade or business includes any income derived from a trade or business in which both personal services and capital are material income producing factors. The term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws of a State, foreign country or possession of the United States. For example, a wife who operates a pharmacy without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control of the business despite the provisions of any community property laws of a State, foreign country, or possession of the United States, vesting in the husband the right of man-

agement and control of community property. The income and deductions attributable to the operation of the pharmacy are considered the income and deductions of the wife.

(4) *Partnership income.* If any portion of a spouse's distributive share of the income of a partnership, of which the spouse is a member, is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not be taken into account in determining the income of the other spouse. If both spouses are members of the same partnership, the distributive share of the income of each spouse which is community income shall be treated as the income of that spouse. A spouse's distributive share of the income of a partnership that is community income shall be determined as provided in section 704 and the regulations thereunder.

(5) *Income from separate property.* Any community income for the taxable year, other than income described in section 879(a) (1) or (2) and paragraph (a) (2), (3), or (4) of this section, which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the State, foreign country, or possession of the United States in which, in accordance with paragraph (a)(1) of this section, the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 879(a) (1), (2), or (3), and paragraph (a) (2), (3), (4), or (5) of this section, shall be treated as income of that spouse who has a proprietary vested interest in that income under the laws of the state, foreign country, or possession of the United States in which, in accordance with paragraph (a)(1) of this section, the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located. Thus, for example, this paragraph (a)(6) applies to community income not described in paragraph (a) (2), (3), (4), or (5) of this section which consists of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children.

(7) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). H, a U.S. citizen, and W, a nonresident alien individual, each of whose taxable years is the calendar year, were married throughout 1977. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. No election under section 6013 (g) or (h) is in effect for 1977. During 1977, H earned $10,000 from the performance of personal services as an employee. H also received $500 in dividend income from stock which under the community property laws of country Z is considered to be the separate property of H. W had no separate income for 1977. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of this income is considered to belong to the other spouse. In addition, the laws of country Z provide that all income derived from property held separately by either spouse is to be treated as community income and treated as belonging one-half to each spouse. Thus, under the community property laws of country Z, H and W are both considered to have realized income of $5,250 during 1977, even though Z's laws recognize the stock as the separate property of H. Under the rules of paragraph (a) (2) and (5) of this section all of the income of $10,500 derived during 1977 is treated, for U.S. income tax purposes, as the income of H.

Example (2). (a) The facts are the same as in example (1), except that H is the sole proprietor of a retail merchandising company, which has a $10,000 profit during 1977. W exercises no management and control over the business. In addition, H is a partner in a wholesale distributing company, and his distributive share of the partnership profit is $5,000. Both of these amounts of income are treated as community income under the community property laws of country Z, and under these laws both H and W are treated as realizing $7,500 of the income. Under the rule of paragraph (a) (3) and (4) of this section all $15,000 of the income is treated as the income of H for U.S. income tax purposes.

(b) If W exercises substantially all of the management and control over the retail merchandising company, then for U.S. income tax purposes the $10,000 profit is treated as the income of W.

Example (3). The facts are the same as in example (1), except that H also received $1,000 in dividends on stock held separately in his name. Under the community property laws of country Z the stock is considered to be community property, the dividends to be community income, and one-half of the income to be the income of each spouse. Under the rule of paragraph (a)(6) of this section, $500 of the dividend income is treated, for U.S. income tax purposes, as the income of each spouse.

(b) *Definitions and other special rules*—(1) *Spouses with different taxable years.* A special rule applies if the nonresident alien and the United States citizen or resident spouse of the alien do not have the same taxable years, as defined in section 441(b) and the regulations thereunder. The special rule is as follows. With respect to the U.S. citizen or resident spouse, section 879 and this section shall apply to each taxable year of the U.S. citizen or resident spouse for which no election under section 6013 (g) or (h) is in effect. With respect to the nonresident alien spouse, section 879 and this section apply to each period falling within the consecutive taxable years of the nonresident alien spouse which coincides with a taxable year of the U.S. citizen or resident spouse to which section 879 and this section apply.

(2) *Determination of marital status.* For purposes of this section, marital status shall be determined under section 143(a).

[T.D. 45 FR 6928, Jan. 31, 1980]

FOREIGN CORPORATIONS

§ 1.881-1 Manner of taxing foreign corporations.

(a) *Classes of foreign corporations.* For purposes of the income tax, foreign corporations are divided into two classes, namely, foreign corporations which at no time during the taxable year are engaged in trade or business in the United States and foreign corporations which, at any time during the taxable year, are engaged in trade or business in the United States.

(b) *Manner of taxing*—(1) *Foreign corporations not engaged in U.S. business.* A foreign corporation which at no time during the taxable year is engaged in trade or business in the United States is taxable, as provided in § 1.881-2, on all income received from sources within the United States which is fixed or determinable annual or periodical income and on other items of income enumerated under section 881(a). Such a foreign corporation is also taxable on certain income from sources within the United States which, pursuant to § 1.882-2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(2) *Foreign corporations engaged in U.S. business.* A foreign corporation which at any time during the taxable year is engaged in trade or business in the United States is taxable, as provided in § 1.882-1, on all income from whatever source derived, whether or not fixed or determinable annual or periodical income, which is effectively connected for the taxable year with the conduct of a trade or business in the United States. Such a foreign corporation is also taxable, as provided in § 1.882-1, on income received from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States and consists of (i) fixed or determinable annual or periodical income, or (ii) other items of income enumerated in section 881(a). A foreign corporation which at any time during the taxable year is engaged in trade or business in the United States is also taxable on certain income from sources within the United States which, pursuant to § 1.882-2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(c) *Meaning of terms.* For the meaning of the term "engaged in trade or business within the United States", as used in section 881 and this section, see section 864(b) and the regulations thereunder. For determining when income, gain, or loss of a foreign corporation for a taxable year is effectively connected for that year with the conduct of a trade or business in the United States, see section 864(c), the regulations thereunder, and § 1.882-2. The term "foreign corporation" has the meaning assigned to it by section 7701(a) (3) and (5) and § 301.7701-5 of this chapter (Regulations on Procedure and Administration), except that, for purposes of section 881 and § 1.881-2, in the case of taxable years beginning after December 31, 1971, the term "foreign corporation" does not include a corporation created or organized in Guam or under the law of Guam. Thus, for example, for such a taxable year the first sentence of paragraph (b)(1), and the second sentence of paragraph (b)(2), of this section do not apply to a Guamanian corporation.

(d) *Rules applicable to foreign insurance companies*—(1) *Corporations qualifying under subchapter L.* A foreign corporation carrying on an insurance business in the United States at any time during the taxable year, which, without taking into account its income not effectively connected for the taxable year with the conduct of a trade or business in the United States, would qualify for the taxable year under part I, II, or III of subchapter L if it were a domestic corporation, shall be taxable for such year under that part on its entire taxable income (whether derived from sources within or without the United States) which is, or which pursuant to section 882 (d) or (e) and § 1.882-2 is treated as, effectively connected for the taxable year with the conduct of a trade or business (whether or not its insurance business) in the United States. Any income derived by that foreign corporation from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States is taxable as provided in section 881(a) and § 1.882-1. See sections 842 and 861 through 864, and the regulations thereunder.

(2) *Corporations not qualifying under subchapter L.* A foreign corporation which carries on an insurance business in the United States at any time during the taxable year, and which, without taking into account its income not effectively connected for the taxable year with the conduct of a trade or business in the United States, would not qualify for the taxable year under part I, II, or III of subchapter L if it were a domestic corporation, and a foreign insurance company which does not carry on an insurance business in the United States at any time during the taxable year, shall be taxable—

(i) Under section 881(a) and § 1.881-2 or § 1.882-1 on its income from sources within the United States which is not effectively connected for the taxable year with the conduct of a trade or business in the United States,

(ii) Under section 882(a)(1) and § 1.882-1 on its income (whether derived from sources within or without the United States) which is effectively connected for the taxable year with the conduct of a trade or business in the United States, and

(iii) Under section 882(a)(1) and § 1.882-1 on its income from sources within the United States which pursuant to section 882 (d) or (e) and § 1.882-2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(e) *Other provisions applicable to foreign corporations*—(1) *Accumulated earnings tax.* For the imposition of the accumulated earnings tax upon the accumulated taxable income of a foreign corporation formed or availed of for tax avoidance purposes, whether or not such corporation is engaged in trade or business in the United States, see section 532 and the regulations thereunder.

(2) *Personal holding company tax.* For the imposition of the personal holding company tax upon the undistributed personal holding company income of a foreign corporation which is a personal holding company, whether or not such corporation is engaged in trade or business in the United States, see sections 541 through 547, and the regulations thereunder. Except in the case of a foreign corporation having personal service contract income to which section 543(a)(7) applies, a foreign corporation is not a personal holding company if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations. See section 542(c)(7).

(3) *Foreign personal holding companies.* For the mandatory inclusion in the gross income of the United States shareholders of the undistributed foreign personal holding company income of a foreign personal holding company, see section 551 and the regulations thereunder.

(4) *Controlled foreign corporations*—(i) *Subpart F income and increase of earnings invested in U.S. property.* For the mandatory inclusion in the gross income of the U.S. shareholders of the Subpart F income, of the previously excluded Subpart F income withdrawn from investment in less developed countries, and of the increase in earnings invested in U.S. property, of a controlled foreign corporation, see sections 951 through 964, and the regulations thereunder.

(ii) *Certain accumulations of earnings and profits.* For the inclusion in the gross income of U.S. persons as a dividend of the gain recognized on certain sales or exchanges of stock in a foreign corporation, to the extent of certain earnings and profits attributable to the stock which were accumulated while the corporation was a controlled foreign corporation, see section 1248 and the regulations thereunder.

(5) *Changes in tax rate.* For provisions respecting the effect of any change in rate of tax during the taxable year on the income of a foreign corporation, see section 21 and the regulations thereunder.

(6) *Consolidated returns.* Except in the case of certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the laws of that country as to title and operation of property, a foreign corporation is not an includible corporation for purposes of the privilege of making a consolidated return by an affiliated group of corporations. See section 1504 and the regulations thereunder.

(7) *Adjustment of tax of certain foreign corporations.* For the application of pre-1967 income tax provisions to corporations of a foreign country which imposes a more burdensome income tax than the United States, and for the adjustment of the income tax of a corporation of a foreign country which imposes a discriminatory income tax on the income of citizens of the United States or domestic corporations, see section 896.

(f) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881-1 (Rev. as of Jan. 1, 1971).

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654(e)) of the Internal Revenue Code of 1954)

[T.D. 7293, 38 FR 32795, Nov. 28, 1973, as amended by T.D. 7385, 40 FR 50260, Oct. 29, 1975]

§ 1.881-2 Taxation of foreign corporations not engaged in U.S. business.

(a) *Imposition of tax.* (1) This section applies for purposes of determining the tax of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States. However, see also § 1.882-2 where such corporation has an election in effect for the taxable year in respect to real property income or receives interest on obligations of the United States. Except as otherwise provided in § 1.871-12, a foreign corporation to which this section applies is not subject to the tax imposed by section 11 or section 1201(a) but, pursuant to the provisions of section 881(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b) and (c) of this section which are received during the taxable year from sources within the United States. Except as specifically provided in such paragraphs, such amounts do not include gains from the sale or exchange of property. To determine the source of such amounts, see sections 861 through 863, and the regulations thereunder.

(2) The tax of 30 percent is imposed by section 881(a) upon an amount only to the extent the amount constitutes gross income.

(3) Deductions shall not be allowed in determining the amount subject to tax under this section.

(4) Except as provided in § 1.882-2, a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States

has no income, gain, or loss for the taxable year which is effectively connected for the taxable year with the conduct of a trade or business in the United States. See section 864(c)(1)(B) and § 1.864-3.

(5) Gains and losses which, by reason of section 882(d) and § 1.882-2, are treated as gains or losses which are effectively connected for the taxable year with the conduct of a trade or business in the United States by such a foreign corporation shall not be taken into account in determining the tax under this section. See, for example, paragraph (c)(2) of § 1.871-10.

(b) *Fixed or determinable annual or periodical income.* The tax of 30 percent imposed by section 881(a) applies to the gross amount received from sources within the United States as fixed or determinable annual or periodical gains, profits, or income. Specific items of fixed or determinable annual or periodical income are enumerated in section 881(a)(1) as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other items of fixed or determinable annual or periodical gains, profits, or income are also subject to the tax as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441-2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income for purposes of section 881(a), see section 306(f) and paragraph (h) of § 1.306-3.

(c) *Other income and gains*—(1) *Items subject to tax.* The tax of 30 percent imposed by section 881(a) also applies to the following gains received during the taxable year from sources within the United States:

(i) Gains described in section 631 (b) or (c), relating to the treatment of gain on the disposal of timber, coal, or iron ore with a retained economic interest;

(ii) [Reserved]

(iii) Gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, or other like property, or of any interest in any such property, to the extent the gains are from payments (whether in a lump sum or in installments) which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged, or from payments which are treated under section 871(e) and § 1.871-11 as being so contingent.

(2) *Determination of amount of gain.* The tax of 30 percent imposed upon the gains described in subparagraph (1) of this paragraph applies to the full amount of the gains and is determined (i) without regard to the alternative tax imposed by section 1201(a) upon the excess of net long-term capital gain over the net short-term capital loss; (ii) without regard to section 1231, relating to property used in the trade or business and involuntary conversions; and (iii) except in the case of gains described in subparagraph (1)(ii) of this paragraph, whether or not the gains are considered to be gains from the sale or exchange of property which is a capital asset.

(d) *Credits against tax.* The credits allowed by section 32 (relating to tax withheld at source on foreign corporations), by section 39 (relating to certain uses of gasoline and lubricating oil), and by section 6402 (relating to overpayments of tax) shall be allowed against the tax of a foreign corporation determined in accordance with this section.

(e) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881-2 (Rev. as of Jan. 1, 1971).

[T.D. 7293, 38 FR 32796, Nov. 28, 1973]

§ 1.882-1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

(a) *Segregation of income.* This section applies for purposes of determining the tax of a foreign corporation which at any time during the taxable year is engaged in trade or business in the United States. It also applies for purposes of determining the tax of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States but has for the taxable year real property income or interest on obligations of the United States which, by reason of section 882 (d) or (e) and § 1.882-2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. A foreign corporation to which this section applies must segregate its gross income for the taxable year into two categories, namely, the income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation and the income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. A separate tax shall then be determined upon each such category of income, as provided in paragraph (b) of this section. The determination of whether income or gain is or is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation shall be made in accordance with section 864(c) and §§ 1.864-3 through 1.864-7. For purposes of this section income which is effectively connected for the taxable year with the conduct of a trade or business in the United States includes all income which is treated under section 882 (d) or (e) and § 1.882-2 as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation.

(b) *Imposition of tax*—(1) *Income not effectively connected with the conduct of a trade or business in the United States.* If a foreign corporation to which this section applies derives during the taxable year from sources within the United States income or gains described in section 881(a) and paragraph (b) or (c) of § 1.881-2 which are not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, such income or gains shall be subject to a flat tax of 30 percent of the aggregate amount of such items. This tax shall be determined in the manner, and subject to the same conditions, set forth in § 1.881-2 as though the income or gains were derived by a foreign corporation not engaged in trade or business in the United States during the taxable year, except that in applying paragraph (c) of such section there shall not be taken into account any gains which are taken into account in determining the tax under section 882(a)(1) and subparagraph (2) of this paragraph.

(2) *Income effectively connected with the conduct of a trade or business in the United States*—(i) *In general.* If a foreign corporation to which this section applies derives income or gains which are effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, the taxable income or gains shall, except as provided in § 1.871-12, be taxed in accordance with section 11 or, in the alternative, section 1201(a). See sections 11(f) and 882(a)(1). Any income of the foreign corporation which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation shall not be taken into account in determining either the rate or amount of such tax.

(ii) *Determination of taxable income.* The taxable income for any taxable year for purposes of this subparagraph consists only of the foreign corporation's taxable income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation; and, for this purpose, it is immaterial that the trade or business with which that income is effectively connected is not the same as the trade or business carried on in the United States by that corporation during the taxable year. See example (2) in § 1.864-4(b). In determining such taxable income all amounts constituting, or considered to be, gains or losses for the taxable year from the sale or exchange of capital assets shall be taken into account if such gains or losses are effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(iii) *Cross references.* For rules for determining the gross income and deductions for the taxable year, see section 882 (b) and (c)(1) and the regulations thereunder.

(c) *Change in trade or business status.* The principles of paragraph (c) of § 1.871-8 shall apply to cases where there has been a change in the trade or business status of a foreign corporation.

(d) *Credits against tax.* The credits allowed by section 32 (relating to tax withheld at source on foreign corporations), section 33 (relating to the foreign tax credit), section 38 (relating to investment in certain depreciable property), section 39 (relating to certain uses of gasoline and lubricating oil), section 40 (relating to expenses of work incentive programs), and section 6042 (relating to overpayments of a tax) shall be allowed against the tax determined in accordance with this section. However, the credits allowed by sections 33, 38, and 40 shall not be allowed against the flat tax of 30 percent imposed by section 881(a) and paragraph (b)(1) of this section. For special rules applicable in determining the foreign tax credit, see section 906(b) and the regulations thereunder. For the disallowance of certain credits where a return is not filed for the taxable year see section 882(c)(2) and the regulations thereunder.

(e) *Payment of estimated tax.* Every foreign corporation which for the taxable year is subject to tax under section 11 or 1201(a) and this section must make payment of its estimated tax in accordance with section 6154 and the regulations thereunder. In determining the amount of the estimated tax the foreign corporation must treat the tax imposed by section 881(a) and paragraph (b)(1) of this section as though it were a tax imposed by section 11.

(f) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.882-1 (Rev. as of Jan. 1, 1971).

[T.D. 7293, 38 FR 32797, Nov. 28, 1973]

§ 1.882-2 Income of foreign corporation treated as effectively connected with U.S. business.

(a) *Election as to real property income.* A foreign corporation which during the taxable year derives any income from real property which is located in the United States, or derives income from any interest in any such real property, may elect, pursuant to section 882(d) and § 1.871-10, to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. The election may be made whether or not the foreign corporation is engaged in trade or business in the United States during the taxable year for which the election is made or whether or not the corporation has income from real property which for the taxable year is effectively connected with the conduct of a trade or business in the United States, but it may be made only with respect to income from sources within the United States which, without regard to section 882(d) and § 1.871-10, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. The income to which the election applies shall be determined as provided in paragraph (b) of § 1.871-10 and shall be subject to tax in the manner, and subject to the same conditions, provided by section 882(a)(1) and paragraph (b)(2) of § 1.882-1. Section 871(d) (2) and (3) and the provisions of § 1.871-10 thereunder shall apply in respect of an election under section 882(d) in the same manner and to the same extent as they apply in respect of elections under section 871(d).

(b) *Interest on U.S. obligations received by banks organized in possessions.* Interest received from sources within the United States during the taxable year on obligations of the United States by a foreign corporation created or organized in, or under the law of, a possession of the United States and carrying on the banking business in a possession of the United States during the taxable year shall be treated, pursuant to section 882(e) and this paragraph, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. This paragraph applies whether or not the foreign corporation is engaged in trade or business in the United States at any time during the taxable year but only with respect to income which, without regard to this paragraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. Any interest to which this paragraph applies shall be subject to tax in the manner, and subject to the same conditions, provided by section 882(a)(1) and paragraph (b)(2) of § 1.882-1. To the extent that deductions are connected with interest to which this paragraph applies, they shall be treated for purposes of section 882(c)(1) and the regulations thereunder as connected with income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation. An election by the taxpayer is not required in respect of the income to which this paragraph applies. For purposes of this paragraph the term "possession of the United States" includes Guam, the Midway Islands, the Panama Canal Zone, the Commonwealth of Puerto Rico, American Samoa, the Virgin Islands, and Wake Island.

(c) *Treatment of income.* Any income in respect of which an election described in paragraph (a) of this section is in effect, and any interest to which paragraph (b) of this section applies, shall be treated, for purposes of paragraph (b)(2) of § 1.882-1 and paragraph (a) of § 1.1441-4, as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by the foreign corporation. A foreign corporation shall not be treated as being engaged in trade or business in the United States merely by reason of having such income for the taxable year.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7293, 38 FR 32798, Nov. 28, 1973]

§ 1.882-3 Gross income of a foreign corporation.

(a) *In general*—(1) *Inclusions.* The gross income of a foreign corporation for any taxable year includes only (i) the gross income which is derived from sources within the United States and which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation and (ii) the gross income, irrespective of whether such income is derived from sources within or without the United States, which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. For the determination of the sources of income, see sections 861 through 863, and the regulations thereunder. For the determination of whether income from sources within or without the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States, see sections 864(c) and 882 (d) and (e), §§ 1.864-3 through 1.864-7, and § 1.882-2.

(2) *Exchange transactions.* Even though a foreign corporation which effects certain transactions in the United States in stocks, securities, or commodities during the taxable year may not, by reason of section 864(b)(2) and paragraph (c) or (d) of § 1.864-2, be engaged in trade or business in the United States during the taxable year through the effecting of such transactions, nevertheless it shall be required to include in gross income for the taxable year the gains and profits from those transactions to the extent required by paragraph (c) of § 1.881-2 or by paragraph (a) of § 1.882-1.

(3) *Exclusions.* For exclusions from gross income of a foreign corporation, see § 1.883-1.

(b) *Foreign corporations not engaged in U.S. business.* In the case of a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States the gross income shall include only (1) the gross income from sources within the United States which is described in section 881(a) and paragraphs (b) and (c) of § 1.881-2, and (2) the gross income from sources within the United States which, by reason of section 882 (d) or (e) and § 1.882-2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(c) *Foreign corporations engaged in U.S. business.* In the case of a foreign corporation which is engaged in trade or business in the United States at any time during the taxable year, the gross income shall include (1) the gross income from sources within and without the United States which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, (2) the gross income from sources within the United States which, by reason of section 882 (d) or (e) and § 1.882-2, is treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation, and (3) the gross income from sources within the United States which is described in section 881(a) and paragraphs (b) and (c) of § 1.881-2 and is not effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.882-2 (Rev. as of Jan. 1, 1971).

[T.D. 7293, 38 FR 32799, Nov. 28, 1973]

§ 1.882-4 Allowance of deductions to foreign corporations.

(a) *Nonresident foreign corporations.* As indicated in § 1.882-3, a nonresident foreign corporation is not allowed any deductions, whether or not a return of income is filed. The deductions allowed such a corporation electing under a tax convention to be subject to tax on a net basis shall be obtained by filing a return of income in the manner prescribed in the regulations under the tax convention. See paragraph (a)(2) of § 1.882-3.

(b) *Resident foreign corporations*—(1) *Return necessary.* A resident foreign corporation shall receive the benefit of the deductions allowed to it with respect to the income tax, only if it files or causes to be filed with the district director, in accordance with section 6012 and the regulations thereunder, a true and accurate return of its total income received from all sources within the United States.

(2) *Tax on gross income.* If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with § 1.882-1 but without regard to any deductions otherwise allowable.

(3) *Return by district director.* If a resident foreign corporation has various sources of income within the United States and a return of income has not been filed by it or on its behalf, the district director shall (i) cause a return of income to be made, (ii) include therein the income described in § 1.882-1 of that corporation from all sources concerning which he has information, and (iii) assess the tax and collect it from one or more of those sources of income within the United States, without allowance for any deductions.

(c) *Allowed deductions*—(1) *In general.* Except for charitable contributions and gifts (see section 882(c)(1)(B)), deductions are allowed to a foreign corporation only to the extent they are connected with gross income which is effectively connected with the conduct of a trade or business in the United States. Deductible expenses (other than interest expense) are properly allocated and apportioned to effectively connected gross income in accordance with the rules of § 1.861-8. For the method of determining the interest deduction allowed to a foreign corporation, see § 1.882-5.

(2) *Verification.* At the request of the Director of International Operations or any district director, a foreign corporation claiming deductions from gross income which is effectively connected with the conduct of a trade or business in the United States must furnish at the place designated pursuant to § 301.7605-1(a) information sufficient to establish that the corporation is entitled to the deductions in

the amounts claimed. All information must be furnished in a form suitable to permit verification of claimed deductions. The Director of International Operations or district director may require, as appropriate, that an English translation be provided with any information in a foreign language. If a foreign corporation fails to furnish sufficient information, the Director of International Operations or district director may in his discretion disallow any claimed deductions in full or in part.

(Sec. 882(c) (80 Stat. 1556; 26 U.S.C. 882(c)) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7749, 46 FR 1683, Jan. 7, 1981]

§ 1.882-5 Determination of interest deduction.

(a) *In general.* The interest deduction allowed a foreign corporation under section 882(c) is determined by the three-step process set forth in paragraph (b) of this section. For purposes of this process, the following rules apply:

(1) *Classification of items.* The classification of items as assets or liabilities must be on a consistent basis from year to year and substantially in accordance with U.S. tax principles.

(2) *Asset valuation.* All assets must be valued on the basis of either U.S. tax book value (adjusted basis for determining gain or loss from sale or other disposition (see section 1011)) or fair market value. The same method must be used for both Step 1 and Step 2 of the three-step process. Once a method is used for a taxable year, that method must be used for all taxable years, unless the Commissioner or his delegate consents to a change. Any reasonable approach for determining fair market value may be used and, as appropriate, different approaches may be used for different types of assets if the same approaches are used consistently from year to year.

(3) *Currency translations.* A particular asset value or liability amount that is denominated in one currency is translated into another currency at the exchange rate for the date the value or amount is determined for purposes of this section. An interest expense amount shown on the books is translated at the exchange rate for the date the amount is paid or accrued. Qualified sources of exchange rates must be determined under the rules of § 1.964-1(d)(5).

(4) *Average total values or amounts.* An average total value of assets, or an average total amount of liabilities, is determined by taking the average of the totals computed at the most frequent, regular intervals (such as daily, weekly, monthly, or quarterly) for which data for all assets, or liabilities, are reasonably available.

(5) *Inter-branch loans.* Assets, liabilities, and interest expense amounts resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation are disregarded.

(6) *Adjustments to reflect substance.* If the substance of a loan or other transaction differs from its form, the Commissioner or his delegate may make appropriate adjustments to reflect the transaction in accordance with its substance. The operation of this rule is illustrated by the following example:

Example. Bank A's head office is located in country X. A also maintains branch banking offices in London and in New York. In 1981, A's London branch takes an unsecured loan of $100x from bank B located in country Y. The loan agreement identifies the borrower as "Bank A (London branch)". The London branch in form loans $100x to the New York branch on the same terms and conditions as the loan from bank B, except that the interest rate is 1/16 percent above the bank B loan rate. The pertinent facts demonstrate that in this case the 1/16 percent additional interest represents a fee paid to the London branch by the New York branch in consideration of the London branch's services in obtaining the loan from bank B. Based on all the pertinent facts and circumstances, the substance of the transaction is that the London branch has acted as agent or broker for the New York branch; accordingly, the New York branch could be treated by the Commissioner or his delegate as having obtained the loan directly from bank B. (The rules of § 1.861.8 would apply in determining the deductibility of expenses incurred by bank A, including expenses incurred by the London branch, in obtaining the loan from bank B.)

(b) *Three-step process.* The three-step process for the determination of the interest deduction allowed to a foreign corporation with respect to its effectively connected gross income is as follows:

(1) *Step 1—Asset determination.* The average total value of all assets of the corporation that generate, have generated, or could reasonably have been or be expected to generate income, gain, or loss effectively connected with the conduct of a trade or business in the United States must be determined for the taxable year (or applicable portion thereof). This average total value must be stated in U.S. dollars.

(2) *Step 2—Liability determination.* The amount of liabilities of the corporation connected with the conduct of a trade or business in the United States must be determined for the taxable year (or portion thereof). This amount of U.S.-connected liabilities is determined by multiplying the asset value determined under Step 1 by one of the following two ratios:

(i) *Fixed ratio.* In the case of a U.S. banking, financing, or similar business (as defined in § 1.864-4(c)(5)(i)), ninety-five percent; in the case of any other U.S. business, fifty percent, or

(ii) *Actual ratio.* The ratio of the average total amount of corporate worldwide liabilities (including those of the U.S. trade or business) for the year (or portion thereof) to the average total value of coporate worldwide assets (including those of the U.S. trade or business) for the year (or portion thereof). For purposes of computing this ratio, all liability amounts and asset values must be consistently stated from year to year either in U.S. dollars or in the currency of the country in which the head office of the corporation is located.

On the corporation's return for the first taxable year (or portion thereof) to which this section applies, the corporation must elect to use either the ratio in (i) or the ratio in (ii). The elected ratio must be used in later taxable years unless the Commissioner or his delegate consents to a change.

(3) *Step 3—Interest deduction allowed.* On the corporation's return for the first taxable year (or portion thereof) to which this section applies, the corporation must elect to use, for determining the amount of its allowed interest deduction, either the branch book/dollar pool method set forth in paragraph (b)(3)(i) of this section or the separate currency pools method set forth in paragraph (b)(3)(ii) of this section. Once made, the election may not be changed for later taxable years (except as provided in this paragraph (b)(3)) without the consent of the Commissioner or his delegate. For its first taxable year beginning after 1980, a corporation may change methods without obtaining the consent of the Commissioner or his delegate.

(i) *Branch book/dollar pool method.* (A) If the amount of U.S.-connected liabilities, determined under Step 2, does not exceed the average total amount of liabilities (in all currencies) shown on the books of the U.S. trade or business (stated in U.S. dollars), the interest expense allowed to the foreign corporation as effectively connected with the conduct of a trade or business in the United States is determined by multiplying the average total amount of U.S.-connected liabilities for the year by the average U.S.-connected interest rate. The average U.S.-connected interest rate is equal to the ratio of the total amount of interest expense shown on the books of the U.S. trade or business for the year (or portion thereof) to the average total amount of liabilities shown on the books of the U.S. trade or business for the year (or portion thereof). Both the numerator and denominator of this ratio must be stated in U.S. dollars.

(B) If the amount of U.S.-connected liabilities exceeds the average total amount of liabilities shown on the books of the U.S. trade or business (stated in U.S. dollars), the allowed interest deduction is equal to the sum of (*1*) the total amount of interest expense for the taxable year (or portion thereof) shown on the books of the U.S. trade or business, and (*2*) the amount of the excess of U.S.-connected liabilities multiplied by the average interest rate on U.S. dollar liabilities for the taxable year (or portion thereof) shown on the books of the offices or branches of the foreign corporation outside the United States. If information providing the actual average non-U.S.-connected interest rate cannot reasonably be obtained, then such interest rate may be determined under any method that reasonably approximates the actual rate and that is consistently applied by the corporation from year to year. For example, reference to quoted London inter-bank offered rates (LIBOR) for time deposits with 30 days to maturity may be appropriate. If a corporation has no more than a *de minimis* amount of U.S. dollar liabilities shown on the books of its non-U.S. offices or branches, then the average U.S.-connected interest rate is applied to the total amount of U.S.-connected liabilities.

(ii) *Separate currency pools method.* Under this method, the total allowed interest deduction is the sum of the separate allowed interest deductions for each currency in which the U.S. trade or business has borrowed. In the case of each such currency, the allowed interest deduction is equal to the product of the following three amounts:

(A) The ratio of the amount of U.S.-connected liabilities for the taxable year (or portion thereof), as determined under Step 2, to the average total amount of liabilities (in all currencies) shown on the books of the U.S. trade or business for the year (or portion thereof). The numerator of this ratio is stated in U.S. dollars (see Steps 1 and 2). The denominator of this ratio is to be stated either in U.S. dollars or in the currency of the country in which the head office of the foreign corporation is located.

(B) The average total amount of liabilities shown on the books of the U.S. trade or business for the year (or portion thereof) denominated in the particular currency. This amount is to be stated in the same currency in which the denominator of the ratio described in (A) above is stated.

(C) The corporation's average worldwide interest rate for that particular currency. This interest rate is equal to the ratio of the total amount of interest expense for the taxable year (or portion thereof) incurred by the corporation (including the U.S. trade or business) with respect to liabilities denominated in the particular currency to the average total amount of liabilities of the corporation (including the U.S. trade or business) for the year (or portion thereof) denominated in that currency. The interest expense and liabilities are to be stated in the particular currency.

A corporation may elect to use the average worldwide interest rate determined in (C) above for U.S. dollars as the average worldwide interest rate for *all* currencies (other than the currency of the country in which the head office of the corporation is located) that meet the following 3-percent rule: for the taxable year (or portion thereof) the average total amount of liabilities shown on the books of the U.S. trade or business denominated in the currency (but stated in the currency in which the denominator of the ratio described in (A) above is stated) is less than 3 percent of the average total amount of all liabilities shown on the books of the U.S. trade or business (stated in the currency in which the denominator of the ratio described in (A) above is stated). Once made, the election may not be changed for later taxable years without the consent of the Commissioner or his delegate.

(c) *Examples.* The rules of this section are illustrated by the following examples:

Example (1). X, a foreign corporation engaged in the banking business, has a U.S. branch, X-U.S., and is a calendar year taxpayer. For 1982 X determines the amount of interest expense it may deduct from its U.S. effectively connected gross income as follows (foreign currency amounts have been translated into U.S. dollars):

(i) *Step 1—Asset determination.* X determines that for 1982 the average total value of all of its assets that generate, have generated, or could reasonably have been or be expected to generate income, gain, or loss effectively connected with the conduct of a U.S. trade or business is $150.

(ii) *Step 2—Liability determination.* X has elected to use its average worldwide liabilities-to-assets ratio (paragraph (b)(2)(ii)). For 1982 the average total amount of its worldwide liabilities is $1,250 and the average total value of its worldwide assets is $1,300. X's average worldwide liabilities-to-assets ratio is equal to:

$$\frac{\text{X's average total amount of liabilities}}{\text{X's average total amount of assets}} = \frac{\$1,250}{\$1,300} = 96.15\%$$

Thus, the amount of X's U.S.-connected liabilities is equal to:

$150 × 96.15%=$144.22

(iii) *Step 3—Interest deduction allowed.* X has elected to use the branch book/dollar pool method (paragraph (b)(3)(i)). For 1982 the average total amount of liabilities shown on the books of X-U.S. (excluding liabilities to the head office or other branches of X) is $100. Because X's U.S.-connected liabilities are greater than the average total amount of X-U.S.'s book liabilities, X must use paragraph (b)(3)(i)(B) to determine its interest deduction. For 1982 the interest expense shown on the books of X-U.S. is $9.50 and the average interest rate incurred by X's non-U.S. branches on U.S. dollars is 9.97%.

Interest expense shown on books of X-U.S	$9.50
Interest expense on excess of X's U.S.-connected liabilities:	
Excess=$144.22—$100=$44.22	
Average interest rate=9.97%	
Interest expense=$44.22 X 9.97%	4.41
Interest deduction	13.91

Example (2). The facts are the same as in Example (1) except that for Step 3 X has elected to use the separate currency pools method (paragraph (b)(3)(ii)). The facts with respect to the liabilities of X and U.S. branch X-U.S. are as follows:

Type of Liabilities Incurred by X-U.S.	Amount of X-U.S. Liabilities	Foreign Corporation X Amount of Worldwide Liabilities	Interest Paid Worldwide	Average Rate of Interest
U.S. dollar-denominated liabilities	$75	$250	$24.38	9.75%
Foreign currency A-denominated liabilities	$15	A50	A3	6%
Foreign currency B-denominated liabilities	$10	B600	B84	14%

The total interest deduction, equal to the sum of the separate deductions for each currency, is determined as follows:

$$\text{U.S. dollar deduction} = \frac{\$144.22}{\$100.00} \times \$75 \times 9.75\% = \$10.55$$

$$\text{Foreign currency A deduction} = \frac{\$144.22}{\$100.00} \times \$15 \times 6\% = 1.30$$

$$\text{Foreign currency B deduction} = \frac{\$144.22}{\$100.00} \times \$10 \times 14\% = \underline{2.02}$$

$$\text{Total interest deduction} = \$13.87$$

(d) *Effective date.* This section applies to periods after February 6, 1981 or, at the option of the taxpayer, to taxable years beginning after the last taxable year ending before February 6, 1981 or, at the option of the taxpayer, to open taxable years beginning after 1976.

(Secs. 882(c) (80 Stat. 1556; 26 U.S.C. 882(c)) and 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7749, 46 FR 1683, Jan. 7, 1981; 46 FR 16100, Mar. 11, 1981]

§ 1.883-1 Exclusions from gross income of foreign corporations.

(a) *Earnings of foreign ships or aircraft*—(1) *Basic rule.* So much of the income from sources within the United States of a foreign corporation as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*—(i) *Ships.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Income tax conventions.* Generally, income of any kind which is exempt, under the provisions of an income tax convention to which the United States is a party, from any tax imposed by subtitle A (relating to income taxes) is not included in the gross income of a foreign corporation. However, see paragraph (a) of § 1.894-1 for certain exceptions to this rule. Income on any tax which imposed by such subtitle is limited by an income tax convention is included in the gross income of a foreign corporation if it is not otherwise excluded from gross income. For the determination of the tax when the taxpayer has income upon which the tax is limited by an income tax convention, see § 1.871-12.

(c) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of sections 861 through 863 and the regulations thereunder, is not included in the gross income of a foreign corporation unless such income is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code. For special rules under a tax convention for determining the sources of income and for excluding, from gross income, income from sources without the United States which is effectively connected with the conduct of a trade or business in the United States, see the applicable tax convention. For determining which income from sources without the United States is effectively connected with the conduct of a trade or business within the United States see section 864(c)(4) and § 1.864-5.

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.883-1 (Rev. as of Jan. 1, 1971).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7293, 38 FR 32799, Nov. 28, 1973; 38 FR 34203, Dec. 12, 1973]

MISCELLANEOUS PROVISIONS

§ 1.891 Statutory provisions; doubling of rates of tax on citizens and corporations of certain foreign countries.

Sec. 891. *Doubling of rates of tax on citizens and corporations of certain foreign countries.* Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

[Sec. 891 as amended by sec. 5(6), Life Insurance Company Tax Act 1955 (70 Stat. 49); sec. 3(f)(1), Life Insurance Company Income Tax Act 1959 (73 Stat. 140)]

[T.D. 6610, 27 FR 8723, Aug. 31, 1962]

§ 1.892-1 Income of foreign governments.

(a) *Manner of taxing*—(1) *In general.* Section 892 provides, in general, that the income of a foreign government from sources within the United States is excluded from gross income and exempt from taxation. Paragraph (b) of this section defines a foreign government. In particular it describes the extent to which either an integral part of a foreign sovereign or an entity created by a foreign sovereign will be treated as a foreign government for purposes of section 892. To the extent that income is derived by such an integral part or entity of a foreign sovereign which does not qualify as a foreign government as defined in paragraph (b) of this section, the income is subject to taxation in accordance with appropriate Internal Revenue Code provisions.

(2) *Foreign government exemption.* The income derived by an integral part or controlled entity of a foreign sovereign from investments in the United States in stocks, bonds, or other securities, owned by such integral part or controlled entity, or from interest on deposits in banks of moneys belonging to such integral part or controlled entity, or from any other investment source within the United States, is generally treated as income of a foreign government, which is not included in gross income and is exempt from taxation.

(3) *Foreign government exemption not available.* (i) Income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. These amounts are included in income and taxed under appropriate Internal Revenue Code provisions.

(ii) Income derived by an entity created by a foreign sovereign that does not qualify as a controlled entity of the foreign sovereign under paragraph (b)(3) of this section is included in the gross income of the entity and taxed under appropriate Internal Revenue Code provisions.

(b) *Foreign government defined*—(1) *Classes of a foreign government.* For purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

(2) *Integral part.* An integral part of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. It does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity.

(3) *Controlled entity.* An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity is a controlled entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

The term "controlled entity" does not include any entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

(4) *Pension trust.* A pension trust established exclusively for employees, or former employees, of a foreign government is a controlled entity if it meets the following requirements:

(i) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by the foreign government; and

(ii) The trust forming a part of the pension plan provides for definitely determinable benefits (defined benefit plan) so that it may be concluded that the income of the trust satisifies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

(5) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

(c) *Characterization of activities*—(1) *Commercial activities.* Except as provided in paragraph (c)(2) of this section, all activities conducted in the United States which are ordinarily conducted with a view towards the current of future production of income (whether or not such income is from sources within the United States) are commercial activities. For example, leases on real or personal property, other than holding leases described in paragraph (c)(2)(i) of this section, is a commercial activity.

(2) *Activities that are not commercial*—(i) *Investments.* Investments in the United States in stocks (whether or not a controlling interest investment), bonds, or other securities, loans, net leases on real property, land which is not producing income (other than on its sale or from an investment in net leases on real property), or the holding of deposits in banks are not commercial activities. consideration of all of the facts and circumstances will determine whether an activity with respect to property described in this paragraph (c)(2)(i) constitutes an investment. The following principles apply in making such a determination;

(*a*) An activity undertaken as a dealer will not be an investment for purposes of this paragraph (c)(2)(i).

(*b*) An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(*c*) Except in the case of holding stock, an activity will not be an investment merely because the income derived from the activity is not effectively connected with the conduct of a trade or business in the United States. For example, a loan made by a bank, loan company, or similar financial business (open in the United States to the general public) does not constitute an investment.

(*d*) *Rules for loans.* [Reserved]

(*e*) *Rules for net leases on real property.* [Reserved]

(ii) *Cultural events.* Performances and exhibitions within the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities.

(iii) *Purchasing.* The mere purchase of goods in the United States for use of the foreign sovereign is not a commercial activity.

(iv) *Activities other than trade or business.* For purposes of this paragraph, a particular activity in the United States that does not constitute the conduct of a trade or business in the United States under section 864(b) will be deemed not to be a commercial activity. This paragraph (c)(2)(iv) does not apply if the activity in any year or period constitutes the conduct of a trade or business in the United States under section 864(b). This paragraph (c)(2)(iv) also does not apply to activities involving real property and leases of personal property.

(v) *Not for profit.* Activities that are not customarily attributable to or carried on by private enterprise for profit in the United States are not commercial activities. The fact that in some instances, Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean that the activity is one described in this paragraph (c)(2)(v). For example, even though the United States Government is engaged in the activity of operating a railroad, operating a railroad is not an activity described in this paragraph (c)(2)(v).

(d) *Other operative sections.* In determining whether income is from sources within or without the United States, see sections 861 through 863 and the regulations thereunder. For purposes of determining whether income is effectively connected with a trade or business, see section 864(c) and the regulations thereunder. For rules with respect to withholding of tax at source, see sections 1441 and 1442 and the regulations thereunder. For rules with respect to methods of accounting and accounting periods, see sections 446 and 441, respectively, and the regulations thereunder.

(e) *Filing of returns.* A return with respect to income taxes under subtitle A shall be made by a foreign sovereign, controlled entity, political subdivision, or a transnational entity with respect to certain amounts included in gross income. See section 6012.

(f) *Relationship of section 892 to certain Code sections*—(1) *Section 893.* The term "foreign government" referred to in section 893 (relating to the exemption for compensation of employees of foreign governments) has the same meaning as given such term in paragraph (b) of this section.

(2) *Section 895.* A foreign central bank of issue (as defined in § 1.895-1(b)) that fails to qualify for the exemption from tax provided be this section may nevertheless by exempt from tax on the items of income described in section 895. Thus, a foreign central bank of issue that is not wholly owned and controlled by a foreign sovereign, although not qualifying for exemption lunder this section, may be exempt under section 895 on the items of income enumerated in that section.

(3) *Section 883(b).* Section 892 and this section do not limit the exemption provided under section 883(b), relating generally to the exemption of earnings derived by foreign participants from the ownership or operation of communications satellite systems.

(4) *Section 1442.* No withholding is required under sections 1441 and 1442 in the case of income exempt from taxation and not included in gross income under paragraph (a)(2) of this section.

(g) *Illustrations.* This section may be illustrated by the following examples:

Example (1). For 1981, the Office of the President of a foreign country makes investments of funds from the foreign sovereign's treasury in publicly traded stocks, bonds, and other securities, and interest bearing bank deposits. The Office of the President has also purchased in 1981 a hotel in the United States which is operated by a U.S. agent. None of the income from all of these activities inures to the benefit of the President (or any other official of the foreign country) in a private or personal capacity. The sovereign's investment activities do not constitute commercial activities under paragraph (c) of this section because the foreign sovereign has made investments in property described in paragraph (c)(2)(i) of this section. Income from these investments is exempt under paragraph (a)(2) of this section. Income derived from the operation of the hotel is subject to tax since the Office of the President is engaged in commercial activities in the United States by reason of its hotel operations and hence the income therefrom is not income of a foreign government under paragraph (a)(3)(i) of this section. By reason of section 864(c)(3) and § 1.864-4 (b), this income is effectively connected for 1981 with the conduct of a trade or business within the United States by the Office of the President and is taxed under section 882.

Example (2). Pursuant to a general agreement on contracts, exchanges, and cooperation between the United States and a foreign country, the State Concert Bureau, a bureau of a foreign sovereign, entered into four separate contracts to be performed in 1981 with a U.S. corporation engaged in the business of promoting international cultural programs. Under the first contract, the State Concert Bureau agreed to send a singer and accompanists on tour for 3 weeks in the United States. Under the second contract, the Bureau agreed to send a conductor on tour for 4 weeks in the United States. Under the third contract, the Bureau agreed to send the State ensemble of folk dance on tour for 5 weeks in the United States. Under the fourth contract, the Bureau agreed to send the State ballet and opera troupe on tour for 6 weeks in the United States. The State Concert Bureau received approximately $80,000 from the performances and from the sale of programs from the tours. This income is exempt from taxation under paragraph (a)(2) of this section since the activities of the Bureau are not commercial activities under paragraph (c)(2)(ii) of this section. Although the performances themselves do not constitute commercial activities, they do constitute the conduct of a trade or business in the United States. As a result, income derived by the State Concert Bureau from sources within the United States from the tour groups' United States radio or television appearances, or from motion picture productions or record and tape recordings of United States performances does not qualify for the exclusion from commercial activities contained in paragraph (c)(2) of this section.

Example (3). In 1981, the Ministry of Culture of foreign country X enters into certain agreements with a U.S. corporation for the television broadcast in the United States of performances by the State ballet troupe during 1981. These performances occur in foreign country X. During 1981, the Ministry of Culture receives $300,000 in royalties and other fees under the terms of the agreement. Since the performances take place outside the United States, and since the activities are not commercial activities under paragraph (c)(2)(iv) of this section, the income from the performances is income of a foreign government and is exempt from taxation under paragraph (a)(2) of this section.

Example (4). (a) In 1981, foreign sovereign Y organizes under its law M Corp. as a wholly owned and controlled government corporation under the auspices of the Ministry of Industry and Tourism. M Corp. engages in the purchasing in the United States of grain and other agricultural goods for free distribution to the poor in country Y. In addition, when purchases of grain exceed demand in foreign country Y (which rarely occurs), M Corp. engages in the sale of grain in the United States. M Corp. also engages in the trading of commodities futures (not for its own account) through a resident broker. Foreign sovereign Y and M Corp. do not have an office or other fixed place of business in the United States through which or by the direction of which the transactions in commodities futures are effected. The purchasing and trading activities of M Corp. are not commercial activities under paragraph (c) of this section. M Corp. is a controlled entity under paragraph (b)(3) of this section. Income from these activities derived by M Corp. from sources within the United States is exempt from taxation under paragraph (a)(2) of this section. However, income derived by M Corp. from the sale of grain in the United States is a commercial activity under paragraph (c) of this section unless M Corp. is not engaged in a trade or business in the United States with respect to its sales activities (paragraph (c)(2)(iv) of this section).

(b) The facts are the same as in example (4)(a), except that in 1982, M Corp. opens an office in Washington, D.C., through which transactions of trading in commodities futures in the United States are effected. These activities are commercial activities under paragraph (c)(1) of this section since M Corp. is now considered to be engaged in a trade or business in the United States under section 864. Thus, paragraph (c)(2)(iv) of this section does not apply. Income from these trading activities is not income of a foreign government under paragraph (a)(3)(i) of this section.

(h) *Effective date.* This section applies to income derived by a foreign sovereign after July 22, 1980, unless the sovereign elects to have it apply to income derived before that date.

[T.D. 7707, 45 FR 48883, July 22, 1980]

§ 1.892–2 Income of international organizations.

(a) *Exempt from tax.* Subject to the provisions of section 1 of the International Organizations Immunities Act (22 U.S.C. 288) (the provisions of which section are set forth in paragraph (b)(3) of § 1.893–1), the income of an international organization (as defined in section 7701(a)(18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax.

(b) *Income received prior to Presidential designation.* An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31; 1960. Redesignated by T.D. 7707, 45 FR 48883, July 22, 1980]

§ 1.893-1 Compensation of employees of foreign governments or international organizations.

(a) *Employees of foreign governments*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)), all employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States, or are citizens of the Republic of the Philippines (whether or not citizens of the United States), are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered to such foreign government, provided (i) the services are of a character similar to those performed by employees of the Government of the United States in that foreign country and (ii) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in that foreign country.

(2) *Certificate by Secretary of State.* Section 893(b) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

(3) *Items not exempt.* The income received by employees of foreign governments from sources other than their salaries, fees, or wages, referred to in subparagraph (1) of this paragraph, is subject to Federal income tax.

(4) *Immigration and Nationality Act.* Section 247(b) of the Immigration and Nationality Act provides as follows:

> Sec. 247. Adjustment of status of certain resident aliens.* * *
>
> (b) The adjustment of status required by subsection (a) [of section 247 of the Immigration and Nationality Act] shall not be applicable in the case of any alien who requests that he be permitted to retain his status as an immigrant and who, in such form as the Attorney General may require, executes and files with the Attorney General a written waiver of all rights, privileges, exemptions, and immunities under any law or any executive order which would otherwise accrue to him because of the acquisition of an occupational status entitling him to a nonimmigrant status under paragraph (15)(A), (15)(E), or (15)(G) of section 101(a).

(5) *Effect of waiver.* An employee of a foreign government who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that alien after the date of filing of the waiver.

(6) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of a foreign government is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(b) *Employees of international organizations*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act and subject to the provisions of sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f), wages, fees, or salary of any officer or employee of an international organization (as defined in section 7701(a)(18)) received as compensation for official services to that international organization is exempt from Federal income tax, if that officer or employee (i) is not a citizen of the United States or (ii) is a citizen of the Republic of the Philippines (whether or not a citizen of the United States).

(2) *Income earned prior to executive action.* An individual of the prescribed class who receives wages, fees, or salary as compensation for official

services to an organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to, and accepted by, the Secretary of State as an officer or employee of that organization, or who has been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective officer or employee of that organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by that individual, either prior to the date of the Issuance of the Executive order, or prior to the date of the acceptance or designation by the Secretary of State, for official services to that organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time the compensation is earned, and (iii) the individual is an officer or employee of that organization at that time.

(3) *International Organizations Immunities Act.* Sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f) provide in part as follows:

> SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term "international organization" means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any such international organization, by appropriate Executive order to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.
>
> * * * * *
>
> SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall have been duly notified to and accepted by the Secretary of State as a * * * officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective * * * officer, or employee; * * *.
>
> (b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the * * * international organization concerned * * *, and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.
>
> (c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.
>
> SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees * * * provided for in this title [International Organizations Immunities Act], shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided,* That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

(4) *Effect of waiver.* An officer or employee of an international organization who executes and files with the Attorney General the waiver provided

for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that individual after the date of filing of the waiver.

(5) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of an international organization is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(c) *Tax conventions, consular conventions, and international agreements*—(1) *Exemption dependent upon internal revenue laws.* A tax convention or consular convention between the United States and a foreign country, which provides that the United States may include in the tax base of its residents all income taxable under the internal revenue laws, and which makes no specific exception for the income of the employees of that foreign government, does not provide any exemption (with respect to residents of the United States) beyond that which is provided by the internal revenue laws. Accordingly, the effect of the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act by an employee of a foreign government which is a party to such a convention is to subject the employee to tax to the same extent as provided in paragraph (a)(5) of this section with respect to the waiver of exemption under section 893.

(2) *Exemption not dependent upon internal revenue laws.* If a tax convention, consular convention, or international agreement provides that compensation paid by the foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act. For examples of exemptions which are not affected by the Immigration and Nationality Act, see article X of the income tax convention between the United States and the United Kingdom (60 Stat. 1383); article IX, section 9(b), of the Articles of Agreement of the International Monetary Fund (60 Stat. 1414); and article VII, section 9(b), of the Articles of Agreement of the International Bank for Reconstruction and Development (60 Stat. 1458).

§ 1.894-1 Income affected by treaty.

(a) *Income exempt under treaty.* Income of any kind is not included in gross income and is exempt from tax under subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross income under section 894(a) and this paragraph does not apply in determining the accumulated taxable income of a foreign corporation under section 535 and the regulations thereunder or the undistributed personal holding company income of a foreign corporation under section 545 and the regulations thereunder. Moreover, the distributable net income of a foreign trust is determined without regard to section 894 and this paragraph, to the extent provided by section 643(a)(6)(B). Further, the compensating tax adjustment required by section 819(a)(3) in the case of a foreign life insurance company is to be determined without regard to section 894 and this paragraph, to the extent required by section 819(a)(3)(A). See § 1.871-12 for the manner of determining the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is reduced under a tax convention.

(b) *Taxpayer treated as having no permanent establishment in the United States*—(1) *In general.* A nonresident alien individual or a foreign corporation, that is engaged in trade or business in the United States through a permanent establishment located therein at any time during a taxable year beginning after December 31, 1966, shall be deemed not to have a permanent establishment in the United States at any time during that year for purposes of applying any exemption from, or reduction in the rate of, any tax under subtitle A of the Code which is provided by any income tax convention with respect to income which is not effectively connected for that year with the conduct of a trade or business in the United States by the taxpayer. This paragraph applies to all treaties or conventions entered into by the United States, whether entered into before, on, or after November 13, 1966, the date of enactment of the Foreign Investors Tax Act of 1966 (80 Stat. 1539). This paragraph is not considered to be contrary to any obligation of the United States under an income tax convention to which it is a party. The benefit granted under section 894(b) and this paragraph applies only to those items of income derived from sources within the United States which are subject to the tax imposed by section 871(a) or 881(a), and section 1441, 1442, or 1451, on the noneffectively connected income received from sources within the United States by a nonresident alien individual or a foreign corporation. The benefit does not apply to any income from real property in respect of which an election is in effect for the taxable year under § 1.871-10 or in determining under section 877(b) the tax of a nonresident alien individual who has lost United States citizenship at any time after March 8, 1965. The benefit granted by section 894(b) and this paragraph is not elective.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). M, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that dividends received from sources within the United States by a corporation of country X not having a permanent establishment in the United States are subject to tax under chapter 1 of the Code at a rate not to exceed 15 percent. During 1967, M is engaged in business in the United States through a permanent establishment located therein and receives $100,000 in dividends from domestic corporation B, which under section 861(a)(2)(A) constitute income from sources within the United States. Under section 864(c)(2) and § 1.864-4(c), the dividends received from B are not effectively connected for 1967 with the conduct of a trade or business in the United States by M. Although M has a permanent establishment in the United States during 1967, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment in the United States during that year with respect to the dividends. Accordingly, in accordance with paragraph (c)(3) of § 1.871-12 the tax on the dividends is $15,000, that is, 15 percent of $100,000, determined without the allowance of any deductions.

Example (2). T, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that an enterprise of country X is not subject to tax under chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that enterprise from sources within the United States. The convention also provides that the tax imposed by chapter 1 of the Code on dividends received from sources within the United States by a corporation of X which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, T is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, T is engaged in a business (business B) in the United States which is not carried on through a permanent establishment. During 1967, T receives from sources within the United States $60,000 in service fees through the operation of business A and $10,000 in dividends through the operation of business B, both of which amounts are, under section 864(c)(2)(B) and § 1.864-4(c)(3), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The service fees are considered to be industrial or commercial profits under the tax convention with country X. Since T has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b), this paragraph, and § 1.871-12 do not apply. Accordingly, for 1967 T's entire income of $70,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of § 1.882-1.

Example (3). S, a corporation organized in foreign country W, uses the calendar year as the taxable year. The United States and country W are parties to an income tax convention which provides in part that a corporation of country W is not subject to tax under chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that corporation from sources within the United States. The convention also provides that the tax imposed by chapter 1 of the Code on dividends received from sources within the United States by a corporation of country W which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, S is engaged in business in the United States through a permanent establishment located therein and derives from sources within the United States $100,000 in service fees which, under section 864(c)(2)(B) and § 1.864-4(c)(3), are effectively connected for that year with the conduct of a trade or business in the United States by S and which are considered to be industrial or commercial profits under the tax convention with country W. During 1967, S also derives from sources within the United States, through another business it carries on in foreign country X, $10,000 in sales income which, under section 864(c)(3) and § 1.864-4(b), is effectively connected for that year with the conduct of a trade or business in the United States by S and $5,000 in dividends which, under section 864(c)(2)(A) and § 1.864-4(c)(2), are not effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country W. Although S is engaged in a trade or business in the United States during 1967 through a permanent establishment located therein, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment therein with respect to the $5,000 in dividends. Accordingly, in accordance with paragraph (c) of § 1.871-12, for 1967 S is subject to a tax of $750 on the dividends ($5,000×.15) and a tax, determined under section 882(a) and § 1.882-1, on its $110,000 industrial or commercial profits.

Example (4). (a) N, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that the tax imposed by chapter 1 of the Code on dividends received from sources within the United States by a corporation of country Z shall not exceed 15 percent of the amount distributed if the recipient does not have a permanent establishment in the United States or, where the recipient does have a permanent establishment in the United States, if the shares giving rise to the dividends are not effectively connected with the permanent establishment. The tax convention also provides that if a corporation of country Z is engaged in industrial or commercial activity in the United States through a permanent establishment in the United States, income tax may be imposed by the United States on so much of the industrial or commercial profits of such corporation as are attributable to the permanent establishment in the United States.

(b) During 1967, N is engaged in a business (business A) in the United States which is not carried on through a permanent establishment in the United States. In addition, N has a permanent establishment in the United States through which it carries on another business (business B) in the United States. During 1967, N holds shares of stock in domestic corporation D which are not effectively connected with N's permanent establishment in the United States. During 1967, N receives $100,000 in dividends from D which, pursuant to section 864(c)(2)(A) and § 1.864-4(c)(2), are effectively connected for that year with the conduct of business A. Under section 861(a)(2)(A) these dividends are treated as income from sources within the United States. In addition, during 1967, N receives from sources within the United States $150,000 in sales income which, pursuant to section 864(c)(3) and § 1.864-4(b), is effectively connected with the conduct of a trade or business in the United States and which is considered to be industrial or commercial profits under the tax convention with country Z. Of these total profits, $70,000 is from business A and $80,000 is from business B. Only the $80,000 of industrial or commercial profits is attributable to N's permanent establishment in the United States.

(c) Since N has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. However, N is entitled to the reduced rate of tax under the tax convention with country Z with respect to the dividends because the shares of stock are not effectively connected with N's permanent establishment in the United States. Accordingly, assuming that there are no deductions connected with N's industrial or commercial profits, the tax for 1967, determined as provided in paragraph (c) of § 1.871-12, is $46,900 as follows:

Tax on nontreaty income:	
$80,000 × .48	$38,400
Less $25,000 × .26	6,500
	31,900
Tax on treaty income:	
$100,000 (gross dividends) × .15	15,000
Total tax	46,900

Example (5). M, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that a corporation of country Z is not subject to tax under chapter 1 of the Code in respect of its commercial and industrial profits except such profits as are allocable to its permanent establishment in the United States. The regulations in this chapter under the tax convention with country Z provide that a corporation of country Z having a permanent establishment in the United States is subject to U.S. tax upon its industrial and commercial profits from sources within the United States and that its industrial and commercial profits from such sources are deemed to be allocable to the permanent establishment in the United States. During 1967, M is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, M is engaged in a business (business B) in foreign country X and none of such business is carried on in the United States. During 1967, M receives from sources within the United States $40,000 in sales income through the operation of business A and $10,000 in sales income through the operation of business B, both of which amounts are, under section 864(c)(3) and § 1.864-4(b), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The sales income is considered to be industrial and commercial profits under the tax convention with country Z. Since M has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. Accordingly, for 1967 M's entire income of $50,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of § 1.882-1.

(c) *Effective date.* This section applies for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.894-1 (Rev. as of Jan. 1, 1971).

[T.D. 7293, 38 FR 32800, Nov. 28, 1973]

§ 1.895-1 Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

(a) *In general.* Income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof, or from interest on deposits with persons carrying on the banking business, is excluded from the gross income of such bank and is exempt from income tax if the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. For purposes of this section and paragraph (i) of § 1.1441-4, obligations of the United States or of any agency or instrumentality thereof include beneficial interests, participations, and other instruments issued under section 302(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717). See 24 CFR Part 1600 et seq.

(b) *Foreign central bank of issue.* (1) A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose law it is organized. See also paragraph (b)(5) of § 1.861-2.

(2) The exclusion granted by section 895 applies to an instrumentality that is separate from a foreign government, whether or not owned in whole or in part by a foreign government. For example, foreign banks organized along the lines of, and performing functions similar to, the Federal Reserve System qualify as foreign central banks of issue for purposes of this section.

(3) The Bank for International Settlements shall be treated as though it were a foreign central bank of issue for purposes of obtaining the exclusion granted by section 895.

(c) *Ownership of United States obligations or bank deposits.* The exclusion does not apply if the obligations or bank deposits from which the income is derived are not owned by the foreign central bank of issue. Obligations held, or deposits made, by a foreign central bank of issue as agent, custodian, trustee, or in any other fiduciary capacity, shall be considered as not owned by such bank for purposes of this section.

(d) *Commercial banking function or other commercial activity.* The exclusion applies only to obligations of the United States or of any agency or instrumentality thereof, or to bank deposits, held for, or used in connection with, the conduct of a central banking function and not to obligations or deposits held for, or used in connection with, the conduct of commercial banking functions or other commercial activities by the foreign central bank.

(e) *Other exclusions.* See section 861(a)(1) (A) and (E) and § 1.861-2(b) (1) and (4), for special rules relating to interest paid or credited before January 1, 1977, on deposits and on similar amounts and for rules on interest derived from bankers' acceptances. For exemption from withholding under § 1.1441-1 on income derived by a foreign central bank of issue, or by the Bank of International Settlements, from obligations of the United States or of any agency or instrumentality thereof, or from bank deposits, see § 1.1441-4(i).

(f) *Effective date.* This section shall apply with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.85-1 (Rev. as of Jan. 1, 1972).

[T.D. 7378, 40 FR 45435, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

INCOME FROM SOURCES WITHOUT THE UNITED STATES

FOREIGN TAX CREDIT

§ 1.901-1 Allowance of credit for taxes.

(a) *In general.* Citizens of the United States, domestic corporations, and certain aliens resident in the United States, domestic corporations, and certain aliens resident in the United States or Puerto Rico may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Code for taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in the following subparagraphs:

(1) *Citizen of the United States.* A citizen of the United States, whether resident or nonresident, may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year to any foreign country or to any possession of the United States; and (ii) his share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(2) *Domestic corporation.* A domestic corporation may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country, or to any possession of the United States; and (ii) the taxes deemed to have been paid or accrued under section 902, 905(b), or 960.

(3) *Alien resident of the United States or Puerto Rico.* An alien resident of the United States, or an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any possession of the United States;

(ii) The amount of any such taxes paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(iii) His share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary, paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year,

(*a*) To any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country, or (*b*) To any possession of the United States, as the case may be.

(b) *Foreign countries which satisfy the similar credit requirement*—(1) *Taxes of foreign country of which alien resident is citizen or subject.* A foreign country of which an alien resident is a citizen or subject allows a similar credit, within the meaning of section 901(b)(3), to a United States citizen residing in such country either—

(i) If such country allows him a credit against its income taxes for the amount of income taxes paid or accrued to the United States; or

(ii) If, in imposing such taxes, such country exempts from taxation the income received by him from sources within the United States (as determined under Part I (section 861 and following), subchapter N, chapter 1 of the Code).

(2) *Taxes of foreign country other than one of which alien resident is citizen or subject.* An alien resident of the United States may claim a credit for income taxes paid or accrued by him to a foreign country other than the one of which he is a citizen or subject if the country of which he is a citizen or subject either—

(i) Allows a credit to a United States citizen residing therein for income taxes paid or accrued by him to such other foreign country; or

(ii) In imposing its income taxes, exempts from taxation the income of a United States citizen residing therein from sources within such other foreign country.

(c) *Deduction denied if credit claimed.* If a taxpayer chooses with respect to any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to income, war profits, and excess profits taxes paid or accrued in such taxable year to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income in such taxable year or any succeeding taxable year. See section 275(a)(4).

(d) *Period during which election can be made or changed.* The taxpayer may, for a particular taxable year, claim the benefits of section 901 (or change his choice if previously made) at any time before the expiration of the period prescribed by section 6511(a) (or section 6511(c) if the period is extended by agreement) for making a claim for credit or refund of the tax imposed by chapter 1 for such taxable year. Such period for such taxable year is determined without regard to the special period prescribed by section 6511(d)(3).

(e) *Joint return.* In the case of a husband and wife making a joint return, credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses.

(f) *Taxes against which credit not allowed*—The credit for taxes shall be allowed only against the tax imposed by chapter 1 of the Code, but it shall not be allowed against the following taxes imposed under that chapter:

(1) The minimum tax for tax preferences imposed by section 56;

(2) The 10 percent tax on premature distributions to owner-employees imposed by section 72(m)(5)(B);

(3) The tax on lump sum distributions imposed by section 402(e);

(4) The additional tax on income from certain retirement accounts imposed by section 408(f);

(5) The tax on accumulated earnings imposed by section 531;

(6) The personal holding company tax imposed by section 541;

(7) The additional tax relating to war loss recoveries imposed by section 1333; and

(8) The additional tax relating to recoveries of foreign expropriation losses imposed by section 1351.

(g) *Taxpayers to whom credit not allowed.* Among those to whom the credit for taxes is not allowed are the following:

(1) A foreign corporation (see section 882(c)(4));

(2) A China Trade Act corporation (see section 942);

(3) A citizen or domestic corporation entitled to the benefits of the exemption provided by section 931 for income from possessions of the United States (see section 931(g));

(4) A nonresident alien, other than an alien individual who is a bona fide

resident of Puerto Rico during the entire taxable year (see sections 874(c) and 901(b)(3));

(5) A citizen of a possession of the United States (except Puerto Rico) who is not otherwise a citizen of the United States and who is not a resident of the United States and persons who are inhabitants of the Virgin Islands (see section 932).

(h) *Taxpayers denied credit in a particular taxable year.* Taxpayers who are denied the credit for taxes for particular taxable years are the following:

(1) An individual who elects to pay the optional tax imposed by section 3, or one who elects under section 144 to take the standard deduction (see section 36);

(2) A taxpayer who elects to deduct taxes paid or accrued to any foreign country or possession of the United States (see sections 164 and 275);

(3) A regulated investment company which has exercised the election under section 853.

(i) *Dividends from a DISC treated as foreign.* For purposes of sections 901 through 906 and the regulations thereunder, any amount treated as a dividend from a corporation which is a DISC or former DISC (as defined in section 992(a) (1) or (3) as the case may be) will be treated as a dividend from a foreign corporation to the extent such dividend is treated under section 861(a)(2)(D) as income from sources without the United States.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6780, 29 FR 18148, Dec. 22, 1964; T.D. 6789, 29 FR 19241, Dec. 31, 1964; T.D. 6795, 30 FR 934, Jan. 29, 1965; T.D. 7283, 38 FR 20824, Aug. 3, 1973; T.D. 7636, 44 FR 47058, Aug. 10, 1979]

§ 1.901-3 Reduction in amount of foreign taxes on foreign mineral income allowed as a credit.

(a) *Determination of amount of reduction*—(1) *In general.* For purposes of determining the amount of taxes which are allowed as a credit under section 901(a) for taxable years beginning after December 31, 1969, the amount of any income, war profits, and excess profits taxes paid or accrued, or deemed to be paid under section 902, during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income (as defined in paragraph (b) of this section) from sources within such country or possession shall be reduced by the amount, if any, by which—

(i) The smaller of—

(*a*) The amount of such foreign income, war profits, and excess profits taxes, or

(*b*) The amount of the tax which would be computed under chapter 1 of the Code for such year with respect to such foreign mineral income if the deduction for depletion were determined under section 611 without regard to the deduction for percentage depletion under section 613, exceeds

(ii) The amount of the tax computed under chapter 1 of the Code for such year with respect to such foreign mineral income.

The reduction required by this subparagraph must be made on a country-by-country basis whether the taxpayer uses for the taxable year the per-country limitation under section 904(a)(1), or the overall limitation under section 904(a)(2), on the amount of taxes allowed as credit under section 901(a).

(2) *Determination of amount of tax on foreign mineral income*—(i) *Foreign tax.* For purposes of subparagraph (1)(i)(*a*) of this paragraph, the amount of the income, war profits, and excess profits taxes paid or accrued during the taxable year to a foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession is an amount which is the greater of—

(*a*) The amount by which the total amount of the income, war profits, and excess profits taxes paid or accrued during the taxable year to such country or possession exceeds the amount of such taxes that would be paid or accrued for such year to such country or possesion without taking into account such foreign mineral income, or

(*b*) The amount of the income, war profits, and excess profits taxes that would be paid or accrued to such country or possession if such foreign mineral income were the taxpayer's only income for the taxable year, except that in no case shall the amount so determined exceed the total of all income, war profits, and excess profits taxes paid or accrued during the taxable year to such country or possession. For such purposes taxes which are paid or accrued also include taxes which are deemed paid under section 902. In the case of a dividend described in paragraph (b)(2)(i)(*a*) of this section which is from sources within a foreign country or possession of the United States and is attributable in whole or in part to foreign mineral income, the amount of the income, war profits, and excess profits taxes deemed paid under section 902 during the taxable year to such country or possession with respect to foreign mineral income from sources within such country or possession is an amount which bears the same ratio to the amount of the income, war profits, and excess profits taxes deemed paid under section 902 during such year to such country or possession with respect to such dividend as the portion of the dividend which is attributable to foreign mineral income bears to the total dividend. For purposes of (*a*) and (*b*) of this subdivision, foreign mineral income is to be reduced by any credits, expenses, losses, and other deductions which are properly allocable to such income under the law of the foreign country or possession of the United States from which such income is derived.

(ii) *U.S. tax.* For purposes of subparagraph (1)(ii) of this paragraph, the amount of the tax computed under chapter 1 of the Code for the taxable year with respect to foreign mineral income from sources within a foreign country or possession of the United States is the greater of—

(*a*) The amount by which the tax under chapter 1 of the Code on the taxpayer's taxable income for the taxable year exceeds a tax determined under such chapter on the taxable income for such year determined without regard to such foreign mineral income, or

(*b*) The amount of tax that would be determined under chapter 1 of the Code if such foreign mineral income were the taxpayer's only income for the taxable year.

For purposes of this subdivision the tax is to be determined without regard to any credits against the tax and without taking into account any tax against which a credit is not allowed under section 901(a). For purposes of (*b*) of this subdivision, the foreign mineral income is to be reduced only by expenses, losses, and other deductions properly allocable under chapter 1 of the Code to such income and is to be computed without any deduction for personal exemptions under section 151 or 642(b).

(iii) *U.S. income tax computed without deduction allowed by section 613.* For purposes of subparagraph (1)(i)(*b*) of this paragraph, the amount of the tax which would be computed under chapter 1 of the Code (without regard to section 613) for the taxable year with respect to foreign mineral income from sources within a foreign country or possession of the United States is the amount of the tax on such income that would be computed under such chapter by using as the allowance for depletion cost depletion computed upon the adjusted depletion basis of the property. For purposes of this subdivision the tax is to be determined without regard to any credits against the tax and without taking into account any tax against which credit is not allowed under section 901(a). If the greater tax with respect to the foreign mineral income under subdivision (ii) of this subparagraph is the tax determined under (*a*) of such subdivision, the tax determined for purposes of subparagraph (1)(i)(*b*) of this paragraph is to be determined by applying the principles of (*a*) (rather than of (*b*)) of subdivision (ii) of this subparagraph. On the other hand, if the greater tax with respect to the foreign mineral income under subdivision (ii) of this subparagraph is the tax determined under (*b*) of such subdivision, the tax determined for purposes of subparagraph (1)(i)(*b*) of this paragraph is to be determined by applying the principles of (*b*) (rather than of (*a*)) of subdivision (ii) of this subparagraph.

(3) *Special rules.* (i) The reduction required by this paragraph in the amount of taxes paid, accrued, or deemed to be paid to a foreign country

or possession of the United States applies only where the taxpayer is allowed a deduction for percentage depletion under section 613 with respect to any part of his foreign mineral income for the taxable year from sources within such country or possession, whether or not such deduction is allowed with respect to the entire foreign mineral income from sources within such country or possession for such year.

(ii) For purposes of this section, the term "foreign country" or "possession of the United States" includes the adjacent continental shelf areas to the extent, and in the manner, provided by section 638(2) and the regulations thereunder.

(iii) The provisions of this section are to be applied before making any reduction required by section 1503(b) in the amount of income, war profits, and excess profits taxes paid or accrued to foreign countries or possessions of the United States by a Western Hemisphere trade corporation.

(iv) If a taxpayer chooses with respect to any taxable year to claim a credit under section 901 and has any foreign mineral income from sources within a foreign country or possession of the United States with respect to which the deduction under section 613 is allowed, he must attach to his return a schedule showing the computations required by subdivisions (i), (ii), and (iii) of subparagraph (2) of this paragraph.

(v) A taxpayer who has elected to use the overall limitation under section 904(a)(2) on the amount of the foreign tax credit for any taxable year beginning before January 1, 1970, may, for his first taxable year beginning after December 31, 1969, revoke his election without first securing the consent of the Commissioner. See paragraph (d) of § 1.904-1.

(b) *Foreign mineral income defined*—(1) *In general.* The term "foreign mineral income" means income (determined under chapter 1 of the Code) from sources within a foreign country or possession of the United States derived from—

(i) The extraction of minerals from mines, wells, or other natural deposits,

(ii) The processing of minerals into their primary products, or

(iii) The transportation, distribution, or sale of minerals or of the primary products derived from minerals.

Any income of the taxpayer derived from an activity described in either subdivision (i), (ii), or (iii) of this subparagraph is foreign mineral income, since it is not necessary that the taxpayer extract, process, and transport, distribute, or sell minerals or their primary products for the income derived from any such activity to be foreign mineral income. Thus, for example, an integrated oil company must treat as foreign mineral income from sources within a foreign country or possession of the United States all income from such sources derived from the production of oil, the refining of crude oil into gasoline, the distribution of gasoline to marketing outlets, and the retail sale of gasoline. Similarly, income from such sources from the refining, distribution, or marketing of fuel oil by the taxpayer is foreign mineral income, whether or not the crude oil was extracted by the taxpayer. In further illustration, income from sources within a foreign country or possession of the United States derived from the processing of minerals into their primary products by the taxpayer is foreign mineral income, whether or not the minerals were extracted, or the primary products were sold, by the taxpayer. Section 901(e) and this section apply whether or not the extraction, processing, transportation, distribution, or selling of the minerals or primary products is done by the taxpayer. Thus, for example, an individual who derives royalty income from the extraction of oil from an oil well in a foreign country has foreign mineral income for purposes of this paragraph. Income from the manufacture, distribution, and marketing of petrochemicals is not foreign mineral income. Foreign mineral income is not limited to gross income from the property within the meaning of section 613(c) and § 1.613-3.

(2) *Income included in foreign mineral income*—(i) *In general.* Foreign mineral income from sources within a foreign country or possession of the

United States includes, but is not limited to—

(*a*) Dividends from such sources, as determined under § 1.902-1(h)(1), received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income described in subparagraph (1) of this paragraph. The portion of such a dividend which is attributable to such income is that amount which bears the same ratio to the total dividend received as the earnings and profits out of which such dividend is paid that are attributable to foreign mineral income bear to the total earnings and profits out of which such dividend is paid. For such purposes, the foreign mineral income of a foreign corporation is its foreign mineral income described in this paragraph (including any dividends described in this (*a*) which are received from another foreign corporation), whether or not such income is derived from sources within the foreign country or possession of the United States in which, or under the laws of which, the former corporation is created or organized. A foreign corporation is considered to have no foreign mineral income for any taxable year beginning before January 1, 1970.

(*b*) Any section 78 dividend to which a dividend described in (*a*) of this subdivision gives rise, but only to the extent such section 78 dividend is deemed paid under paragraph (a)(2)(i) of this section with respect to foreign mineral income from sources within such country or possession and to the extent it is treated under of § 1.902-1(h)(1) as income from sources within such country or possession.

(*c*) Any amounts includible in income of the taxpayer under section 702(a) as his distributive share of the income of a partnership consisting of income described in subparagraph (1) of this paragraph.

(*d*) Any amounts includible in income of the taxpayer by virtue of section 652(a), 662(a), 671, 682(a), or 691(a), to the extent such amounts consist of income described in subparagraph (1) of this paragraph.

(ii) *Illustration.* The provisions of this subparagraph may be illustrated by the following example:

Example. (a) Throughout 1974, M, a domestic corporation, owns all the one class of stock of N, a foreign corporation which is not a less developed country corporation within the meaning of section 902(d). Both corporations use the calendar year as the taxable year. N is incorporated in foreign country Y. During 1974, N has income from sources within foreign country X, all of which is foreign mineral income. During 1974, N also has income from sources within country Y, none of which is foreign mineral income. N is taxed in each foreign country only on income derived from sources within that country. Neither country X nor country Y allows a credit against its tax for foreign income taxes. N pays a dividend of $40,000 to M for 1974. For purposes of section 902, the dividend is paid from earnings and profits for 1974.

(b) N's earnings and profits and taxes for 1974 are determined as follows:

Foreign mineral income from country X		$100,000
Less:		
Intangible drilling and development costs	$21,000	
Cost depletion	3,000	24,000
Taxable income from country X		76,000
Income tax rate of country X		×50%
Tax paid to country X		38,000
Income from country Y		100,000
Less deductions		25,000
Taxable income from country Y		75,000
Income tax rate of country Y		×60%
Tax paid to country Y		45,000
Total taxable income		151,000
Less total foreign income taxes		83,000
Total earnings and profits		68,000
Taxable income from foreign mineral income		76,000
Less: Tax paid on foreign mineral income		38,000
Earnings and profits from foreign mineral income		38,000

(c) For 1974, M has foreign mineral income from country Y of $49,636.68, determined in the following manner and by applying this section, § 1.78-1, and § 1.902-1(h)(1):

Portion of dividend from country Y attributable to foreign mineral income (subdivision (i)(*a*) of this subparagraph) ($40,000 × $38,000/$68,000)	$22,352.94
Foreign income tax deemed paid by M to country Y under section 902(a)(1) ($83,000 × $40,000/$68,000)	48,823.53

Foreign income tax deemed paid by M to country Y with respect to foreign mineral income from country Y (paragraph (a)(2)(i) of this section) ($48,823.53 × $22,352.94/$40,000)	27,283.74
Foreign mineral income from country Y:	
Dividend attributable to foreign mineral income from country Y	22,352.94
Sec. 78 dividend deemed paid with respect to foreign mineral income (subdivision (i)(*b*) of this subparagraph)	27,283.74
Total foreign mineral income	49,636.68

(c) *Limitations on foreign tax credit*—(1) *In general.* The reduction under section 901(e) and paragraph (a)(1) of this section in the amount of foreign taxes allowed as a credit under section 901(a) is to be made whether the per-country limitation under section 904(a)(1) or the overall limitation under section 904(a)(2) is used for the taxable year, but the reduction in the amount of foreign taxes allowed as a credit under section 901(a) must be made on a country-by-country basis before applying the limitation under section 904(a) to the reduced amount of taxes. If for the taxable year the separate limitation under section 904(f) applies to any foreign mineral income, that limitation must also be applied after making the reduction under section 901(e) and paragraph (a)(1) of this section.

(2) *Carrybacks and carryovers of excess tax paid*—(i) *In general.* Any amount by which (*a*) any income, war profits, and excess profits taxes paid or accrued, or deemed to be paid under section 902, during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession exceed (b) the reduced amount of such taxes as determined under paragraph (a)(1) of this section may not be deemed paid or accrued under section 904(d) in any other taxable year. See § 1.904-2(b)(2)(iii). However, to the extent such reduced amount of taxes exceeds the applicable limitation under section 904(a) for the taxable year it shall be deemed paid or accrued under section 904(d) in another taxable year as a carryback or carryover of an unused foreign tax. The amount so deemed paid or accrued in another taxable year is not, however, deemed paid or accrued with respect to foreign mineral income in such other taxable year. See § 1.904-2(c)(3).

(ii) *Carryovers to taxable years beginning after December 31, 1969.* Where, under the provisions of section 904(d), taxes paid or accrued, or deemed to be paid under section 902, to any foreign country or possession of the United States in any taxable year beginning before January 1, 1970, are deemed paid or accrued in one or more taxable years beginning after December 31, 1969, the amount of such taxes so deemed paid or accrued shall not be deemed paid or accrued with respect to foreign mineral income and shall not be reduced under section 901(e) and paragraph (a)(1) of this section.

(iii) *Carrybacks to taxable years beginning before January 1, 1970.* Where income, war profits, and excess profits taxes are paid or accrued, or deemed to be paid under section 902, to any foreign country or possession of the United States in any taxable year beginning after December 31, 1969, with respect to foreign mineral income from sources within such country or possession, they must first be reduced under section 901(e) and paragraph (a)(1) of this section before they may be deemed paid or accrued under section 904(d) in one or more taxable years beginning before January 1, 1970.

(d) *Illustrations.* The application of this section may be illustrated by the following examples, in which the surtax exemption provided by section 11(d) and the tax surcharge provided by section 51(a) are disregarded for purposes of simplification:

Example (1). (a) M, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country W. For 1971, M's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country W and is subject to the allowance for depletion. During 1971, M incurs intangible drilling and development costs of $15,000, which are currently deductible for purposes of the tax of both countries. Cost depletion amounts to $2,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country W. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country W on such foreign mineral income is $41,500, and the U.S. tax on such income before allowance of the foreign tax credit is $30,240, determined as follows:

	U.S. tax	W tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	15,000	15,000
Cost depletion		2,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $85,000)	22,000	
Taxable income	63,000	83,000
Income tax rate	48%	50%
Tax	30,240	41,500

(b) Without taking this section into account, M would be allowed a foreign tax credit for 1971 of $30,240 ($30,240×$63,000/$63,000), and foreign income tax in the amount of $11,260 ($41,500 less $30,240) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $31,900, determined as follows:

Foreign income tax paid on foreign mineral income		$41,500
Less reduction under sec. 901(e):		
Smaller of $41,500 (tax paid to country W on foreign mineral income) or $39,840 (U.S. tax on foreign mineral income of $83,000 ($83,000×48%), determined by deducting cost depletion of $2,000 in lieu of percentage depletion of $22,000)	39,840	
Less: U.S. tax on foreign mineral income (before credit)	$30,240	9,600
Foreign income tax allowable as a credit		31,900

(d) After taking this section into account, M is allowed a foreign tax credit for 1971 of $30,240 ($30,240×$63,000/$63,000). The amount of foreign income tax which may be first carried back to 1969 under section 904(d) is reduced from $11,260 to $1,660 ($31,900 less $30,240).

Example (2). (a) M, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country X. For 1972, M has gross income under chapter 1 of the Code of $100,000, all of which is foreign mineral income from a property in country X and is subject to the allowance for depletion. During 1972, M incurs intangible drilling and development costs of $50,000 which are currently deductible for purposes of the U.S. tax but which must be amortized for purposes of the tax of country X. Percentage depletion of $22,000 is allowed as a deduction by both countries. For purposes of the U.S. tax, cost depletion for 1972 amounts to $15,000. It is assumed that no other deductions are allowable under the law of either country. Based upon these facts, the income tax paid to country X on such foreign mineral income is $27,200, and the U.S. tax on such income before allowance of the foreign tax credit is $13,440, determined as follows:

	U.S. tax	X tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	50,000	10,000
Percentage depletion	22,000	22,000
Taxable income	28,000	68,000
Income tax rate	48%	40%
Tax	13,440	27,200

(b) Without taking this section into account, M would be allowed a foreign tax credit for 1972 of $13,440 ($13,440×$28,000/$28,000), and foreign income tax in the amount of $13,760 ($27,200 less $13,440) would first be carried back to 1970 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $23,840, determined as follows:

Foreign income tax paid on foreign mineral income		$27,200
Less reduction under sec. 901(e):		
Smaller of $27,200 (tax paid to country X on foreign mineral income) or $16,800 (U.S. tax on foreign mineral income of $35,000 ($35,000×48%), determined by deducting cost depletion of $15,000 in lieu of percentage depletion of $22,000)	$16,800	
Less: U.S. tax on foreign mineral income (before credit)	13,440	3,360
Foreign income tax allowable as a credit		23,840

(d) After taking this section into account, M is allowed a foreign tax credit of $13,440 ($13,440×$28,000/$28,000). The amount of foreign income tax which may be first carried back to 1970 under section 904(d) is reduced from $13,760 to $10,400 ($23,840 less $13,440).

Example (3). (a) N, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country Y. For 1972, N's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country Y and is subject to the allowance for depletion. During 1972, N incurs intangible drilling and development costs of $15,000, which are currently deductible for purposes of the U.S. tax but are not deductible under the law of country Y. Depreciation of $40,000 is allowed as a deduction for purposes of the U.S. tax; and of $20,000, for purposes of the Y tax. Cost depletion amounts to $10,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country Y. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country Y on such foreign mineral income is $14,000, and the U.S. tax on such income before allowance of the foreign tax credit is $11,040, determined as follows:

	U.S. tax	Y tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	15,000	
Depreciation	40,000	20,000
Cost depletion		10,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $45,000)	22,000	
Taxable income	23,000	70,000
Income tax rate	48%	20%
Tax	11,040	14,000

(b) Without taking this section into account, N would be allowed a foreign tax credit for 1972 of $11,040 ($11,040×$23,000/$23,000), and foreign income tax in the amount of $2,960 ($14,000 less $11,040) would first be carried back to 1970 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $11,040, determined as follows:

Foreign income tax paid on foreign mineral income		$14,000
Less reduction under sec. 901(e):		
Smaller of $14,000 (tax paid to country Y on foreign mineral income) or $16,800 (U.S. tax on foreign mineral income of $35,000 ($35,000×48%), determined by deducting cost depletion of $10,000 in lieu of percentage depletion of $22,000)	$14,000	
Less: U.S. tax on foreign mineral income (before credit)	11,040	2,960
Foreign income tax allowable as a credit		11,040

(d) After taking this section into account, N is allowed a foreign tax credit for 1972 of $11,040 ($11,040×$23,000/$23,000), but no foreign income tax is carried back to 1970 under section 904(d) since the allowable credit of $11,040 does not exceed the limitation of $11,040.

Example (4). (a) D, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in foreign country Z. For 1971, D's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country Z and is subject to the allowance for depletion. During 1971, D incurs intangible drilling and development costs of $85,000, which are currently deductible for purposes of the U.S. Tax but are not deductible under the law of country Z. Cost depletion in the amount of $10,000 is allowed as a deduction for purposes of both the U.S. tax and the tax of country Z. Percentage depletion is not allowed as a deduction under the law of country Z and is not taken as a deduction for purposes of the U.S. tax. It is assumed that no other deductions are allowable under the law of either country. Based upon the facts assumed, the income tax paid to country Z on such foreign mineral income is $27,000, and the U.S. tax on such income before allowance of the foreign tax credit is $2,400, determined as follows:

	U.S. tax	Z tax
Foreign mineral income	$100,000	$100,000
Less:		
Intangible drilling and development costs	85,000	
Cost depletion	10,000	10,000
Taxable income	5,000	90,000
Income tax rate	48%	30%
Tax	2,400	27,000

(b) Section 901(e) and this section do not apply to reduce the amount of the foreign income tax paid to country Z with respect to the foreign mineral income since for 1971 D is not allowed the deduction for percentage depletion with respect to any foreign mineral income from sources within country Z. Accordingly, D is allowed a foreign tax credit of $2,400 ($2,400×$5,000/$5,000), and foreign income tax in the amount of $24,600 ($27,000 less $2,400) is first carried back to 1969 under section 904(d).

Example (5). (a) R, a domestic corporation using the calendar year as the taxable year, is an operator drilling for oil in the United States and in foreign country Z. For 1971, R's gross income under chapter 1 of the Code is $250,000, of which $100,000 is foreign mineral income from a property in foreign country Z and $150,000 is from a property in the United States, all being subject to the allowance for depletion. During 1971, R incurs intangible drilling and development costs of $125,000 in the United States and of $25,000 in country Z, all of which are currently deductible for purposes of the U.S. tax. Of these costs of $25,000 incurred in country Z, only $2,500 is currently deductible under the law of country Z. Cost depletion in the case of the U.S. property amounts to $60,000; and in the case of the property in country Z, to $5,000, which is allowed as a deduction under the laws of such country. Percentage depletion is not allowed as a deduction under the law of country Z. In computing the U.S. tax for 1971, R is required to use cost depletion with respect to the mineral income from the U.S. property and percentage depletion with respect to the foreign mineral income from the property in country Z. It is assumed that no other deductions are allowed under the law of either country. Based upon the facts assumed, the income tax paid to country Z on the foreign mineral income from sources therein is $37,000, and the U.S. tax on the entire mineral income before allowance of the foreign tax credit is $8,640, determined as follows:

	U.S. tax	Z tax
Gross income (including foreign mineral income)	$250,000	$100,000
Less:		
Intangible drilling and development costs	150,000	2,500
Cost depletion	60,000	5,000
Percentage depletion on foreign mineral income (22% of $100,000, but not to exceed 50% of [$100,000-$25,000])	22,000	
Taxable income	18,000	92,500
Income tax rate	48%	40%
Tax	8,640	37,000

(b) Without taking this section into account, R would be allowed a foreign tax credit for 1971 of $8,640 ($8,640×$18,000/$18,000), and foreign income tax in the amount of $28,360 ($37,000 less $8,640) would first be carried back to 1969 under section 904(d).

(c) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1971 with respect to foreign mineral income from country Z is $25,440, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country Z (determined under paragraph (a)(2)(ii)(*a*) of this section):

U.S. tax on total taxable income		$8,640
Less U.S. tax on taxable income other than foreign mineral income from country Z:		
Income from U.S. property	$150,000	
Intangible drilling and development costs	125,000	
Cost depletion	60,000	
Taxable income	0	
Income tax rate	48%	
U.S. tax	0	0
Excess tax		8,640

(2) U.S. tax on foreign mineral income from country Z (determined under paragraph (a)(2)(ii)(*b*) of this section):

Foreign mineral income	$100,000
Intangible drilling and development costs	25,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $75,000)	22,000
Taxable income	53,000
Income tax rate	48%
U.S. tax	25,440

(d) Under paragraph (a)(2)(iii) of this section, the amount of the U.S. tax which would be computed for 1971 (without regard to section 613) with respect to foreign mineral income from sources within country Z is $33,600, computed by applying the principles of paragraph (a)(2)(ii)(*b*) of this section:

Foreign mineral income	$100,000
Intangible drilling and development costs	25,000
Cost depletion	5,000
Taxable income	70,000
Income tax rate	48%
U.S. tax	33,600

(e) Pursuant to paragraph (a)(1) of this section, the foreign income tax allowable as a credit against the U.S. tax for 1971 is reduced to $28,840, determined as follows:

Foreign income tax paid on foreign mineral income		$37,000
Less reduction under sec. 901(e):		
Smaller of $37,000 (tax paid to country Z on foreign mineral income) or $33,600 (U.S. tax on foreign mineral income of $70,000, as determined under paragraph (d) of this example	$33,600	
Less: U.S. tax on foreign mineral income of $53,000, as determined under paragraph (c) of this example	25,440	8,160
Foreign income tax allowable as a credit		$28,840

(f) After taking this section into account, R is allowed a foreign tax credit for 1971 of $8,640 ($8,640×$18,000/$18,000). The amount of foreign income tax which may be first carried back to 1969 under section 904(d) is reduced from $28,360 to $20,200 ($28,840 less $8,640).

Example (6). (a) B, a single individual using the calendar year as the taxable year, is an operator drilling for oil in foreign countries X and Y. For 1972, B's gross income under chapter 1 of the Code is $250,000, of which $150,000 is foreign mineral income from a property in country X and $100,000 is foreign mineral income from a property in country Y, all being subject to the allowance for depletion. The assumption is made that B's earned taxable income for 1972 is insufficient to cause section 1348 to apply. During 1972, B incurs intangible drilling and development costs of $16,000 in country X and of $9,000 in country Y, which are currently deductible for purposes of both the U.S. tax and the tax of countries X and Y, respectively. For purposes of both the U.S. tax and the tax of countries X and Y, respectively, cost depletion in the case of the X property amounts to $8,000, and in the case of Y property, to $7,000; and only cost depletion is allowed as a deduction under the law of countries X and Y. For 1972, B uses the overall limitation under section 904(a)(2) on the foreign tax credit. Percentage depletion is not allowed as a deduction under the law of countries X and Y. It is assumed that the only other allowable deductions amount to $2,250. None of these deductions is attributable to the income from the properties in countries X and Y, and none is deductible under the laws of country X or country Y. Based upon the facts assumed, the income tax paid to countries X and Y on the foreign mineral income from each such country is $71,820 and $25,200, respectively, and the U.S. tax on B's total taxable income before allowance of the foreign tax credit is $99,990, determined as follows:

	U.S. Tax	X tax	Y tax
Total income (including foreign mineral income from countries X and Y)	$250,000	$150,000	$100,000
Intangible drilling and development costs	25,000	16,000	9,000
Cost depletion		8,000	7,000
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000; plus 22% of $100,000, but not to exceed 50% of $91,000)	55,000		
Adjusted gross income	170,000		
Other deductions	2,250		
Personal exemption	750		
Taxable income	167,000	126,000	84,000
Income tax rate		57%	30%
Foreign tax		71,820	25,200
U.S. tax ($53,090 plus 70% of $67,000)	99,990		

(b) Without taking this section into account, B would be allowed a foreign tax credit for 1972 of $97,020 ($71,820+$25,200), but not to exceed the overall limitation under section 904(a)(2) of $99,990 ($99,990 ×$167,750/$167,750). There would be no foreign income tax carried back to 1970 under section 904(d) since the allowable credit of $97,020 does not exceed the limitation of $99,990.

(c) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1972 with respect to foreign mineral income from sources within country X is $69,760, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country X (determined under paragraph (a)(2)(ii)(*a*) of this section):

U.S. tax on total taxable income		$99,990
Less U.S. tax on taxable income other than foreign mineral income from country X:		
Foreign mineral income from country Y	$100,000	
Intangible drilling and development costs	9,000	
Percentage depletion (22% of $100,000, but not to exceed 50% of $91,000)	22,000	
Adjusted gross income	69,000	
Other deductions	2,250	
Personal exemption	750	
Taxable income	66,000	
U.S. tax ($26,390 plus 64% of $6,000)		30,230
Excess tax		69,760

(2) U.S. tax on foreign mineral income from country X (determined under paragraph (a)(2)(ii)(*b*) of this section):

Foreign mineral income from country X	$150,000.00
Intangible drilling and development costs	16,000.00
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000)	33,000.00
Adjusted gross income	101,000.00
Other deductions	
Taxable income	101,000.00
U.S. tax ($53,090 plus 70% of excess over $100,000)	53,790.00

(d) Under paragraph (a)(2)(iii) of this section, and by applying the principles of paragraph (a)(2)(ii)(*a*) of this section, the amount of the U.S. tax which would be computed for 1972 (without regard to section 613) with respect to foreign mineral income from sources within country X is $87,920, which is the excess of the U.S. tax ($127,990) determined under subparagraph (1) over the U.S. tax ($40,070) determined under subparagraph (2):

(1) U.S. tax on total taxable income determined without regard to section 613:

Total income	$250,000
Intangible drilling and development costs	25,000
Cost depletion	15,000
Adjusted gross income	210,000
Other deductions	2,250
Personal exemption	750
Taxable income	207,000
U.S. tax ($53,090 plus 70% of $107,000)	127,990

(2) U.S. tax on total taxable income other than foreign mineral income from country X, determined without regard to section 613:

Foreign mineral income from country Y	$100,000
Intangible drilling and development costs	9,000

Cost depletion	7,000
Adjusted gross income	84,000
Other deductions	2,250
Personal exemption	750
Taxable income	81,000
U.S. tax ($39,390 plus 68% of $1,000)	40,070

(*e*) Under paragraph (a)(2)(i) of this section, the amount of income tax paid to country X for 1972 with respect to foreign mineral income from sources within such country is $71,820. This is the amount determined under both (*a*) and (*b*) of paragraph (a)(2)(i) of this section, since, in this case, there is no income from sources within country X other than foreign mineral income, and there are no deductions allowed under the law of country X which are not allocable to such foreign mineral income.

(*f*) Pursuant to paragraph (a)(1) of this section, the foreign income tax with respect to foreign mineral income from sources within country X which is allowable as a credit against the U.S. tax for 1972 is reduced to $69,760, determined as follows:

Foreign income tax paid to country X on foreign mineral income		$71,820
Less reduction under sec. 901(e):		
Smaller of $71,820 (tax paid to country X on foreign mineral income) or $87,920 (U.S. tax on foreign mineral income from sources within country X, as determined under paragraph (d) of this example)	$71,820	
Less: U.S. tax on foreign mineral income from sources within country X, determined under paragraph (c) of this example	69,760	2,060
Foreign income tax of country X allowable as a credit		69,760

(*g*) Under paragraph (a)(2)(ii) of this section, the amount of the U.S. tax for 1972 with respect to foreign mineral income from sources within country Y is $48,280, which is the greater of the amounts of tax determined under subparagraphs (1) and (2):

(1) U.S. tax on total taxable income in excess of U.S. tax on taxable income excluding foreign mineral income from country Y (determined under paragraph (a)(2)(ii)(*a*) of this section):

U.S. tax on total taxable income		$99,990
Less U.S. tax on taxable income other than foreign mineral income from country Y:		
Foreign mineral income from country X	$150,000	
Intangible drilling and development costs	16,000	
Percentage depletion (22% of $150,000, but not to exceed 50% of $134,000)	33,000	
Adjusted gross income	101,000	
Other deductions	2,250	
Personal exemption	750	
Taxable income	98,000	
U.S. tax ($46,190 plus 69% of $8,000)		51,710
Excess tax		48,280

(2) U.S. tax on foreign mineral income from country Y (determined under paragraph (a)(2)(ii)(*b*) of this section):

Foreign mineral income from country Y	$100,000
Intangible drilling and development costs	9,000
Percentage depletion (22% of $100,000, but not to exceed 50% of $91,000)	22,000
Adjusted gross income	69,000
Other deductions	
Taxable income	69,000
U.S. tax ($26,390 plus 64% of $9,000)	32,150

(*h*) Under paragraph (a)(2)(iii) of this section, and by applying the principles of paragraph (a)(2)(ii)(*a*) of this section, the amount of the U.S. tax which would be computed for 1972 (without regard to section 613) with respect to foreign mineral income from sources within country Y is $58,800, which is the excess of the U.S. tax ($127,990) determined under paragraph (d)(1) of this example over the U.S. tax ($69,190) on total taxable income other than foreign mineral income from country Y, determined without regard to section 613, as follows:

Foreign mineral income from country X	$150,000
Intangible drilling and development costs	16,000
Cost depletion	8,000
Adjusted gross income	126,000
Other deductions	2,250
Personal exemption	750
Taxable income	123,000
U.S. tax ($53,090 plus 70% of $23,000)	69,190

(*i*) Under paragraph (a)(2)(i) of this section, the amount of income tax paid to country Y for 1972 with respect to foreign mineral income from sources within such country is $25,200. This is the amount determined under both (*a*) and (*b*) of paragraph (a)(2)(i) of this section, since, in this case, there is no income from sources within country Y other than foreign mineral income, and there are no deductions allowed under the law of country Y which are not allocable to such foreign mineral income.

(*j*) Pursuant to paragraph (a)(1) of this section, the foreign income tax with respect to foreign mineral income from sources within country Y which is allowable as a credit against the U.S. tax for 1972 is not reduced from $25,200, as follows:

Foreign income tax paid to country Y on foreign mineral income		$25,200
Less reduction under sec. 901(e):		
Smaller of $25,200 (tax paid to country Y on foreign mineral income) or $58,800 (U.S. tax on foreign mineral income from sources within country Y, as determined under paragraph (h) of this example)	$25,200	
Less: U.S. tax on foreign mineral income from sources within country Y, as determined under paragraph (g) of this example	48,280	
Foreign income tax of country Y allowable as a credit		25,200

(k) After taking this section into account, B is allowed a foreign tax credit for 1972 of $94,960 ($69,760 + $25,200), but not to exceed the overall limitation under section 904(a)(2) of $99,990 ($99,990 × $167,750/$167,750). There would be no foreign income tax carried back to 1970 under section 904(d) since the allowable credit of $94,960 does not exceed the limitation of $99,990.

Example (7). (a) P, a domestic corporation using the calendar year as the taxable year, is an operator mining for iron ore in foreign country X. For 1971, P's gross income under chapter 1 of the Code is $100,000, all of which is foreign mineral income from a property in country X and is subject to the allowance for depletion. For 1971, cost depletion amounts to $5,000 for purposes of the tax of both countries, and only cost depletion is allowed as a deduction under the law of country X. It is assumed that deductions (other than for depletion) attributable to the mineral property in country X amount to $8,000, and these deductions are allowable under the law of both countries. Based upon the facts assumed, the income tax paid to country X on such foreign mineral income is $39,150, and the U.S. tax on such income before allowance of the foreign tax credit is $37,440 determined as follows:

	U.S. tax	X tax
Foreign mineral income	$100,000	$100,000
Less:		
Percentage depletion (14% of $100,000, but not to exceed 50% of $92,000)	14,000	
Cost depletion		5,000
Other deductions	8,000	8,000
Taxable income	78,000	87,000
Income tax rate	48%	45%
Tax	37,440	39,150

(b) Without taking this section into account, P would be allowed a foreign tax credit for 1971 of $37,440 ($37,440 × $78,000/$78,000), and foreign income tax in the amount of $1,710 ($39,150 less $37,440) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced to $37,440, determined as follows:

Foreign income tax paid on foreign mineral income		$39,150
Less reduction under sec. 901(e):		
Smaller of $39,150 (tax paid to country X on foreign mineral income) or $41,760 (U.S. tax on foreign mineral income of $87,000 ($87,000 × 48%), determined by deducting cost depletion of $5,000 in lieu of percentage depletion of $14,000)	$39,150	
Less: U.S. tax on foreign mineral income (before credit)	37,440	1,710
Foreign income tax allowable as a credit		37,440

(d) After taking this section into account, P is allowed a foreign tax credit for 1971 of $37,440 ($37,440 × $78,000/$78,000), but no foreign income tax is carried back to 1969 under section 904(d) since the allowable credit of $37,440 does not exceed the limitation of $37,440.

Example (8). (a) The facts are the same as in example (7), except that P is assumed to have received dividends for 1971 of $25,000 from R, a foreign corporation incorporated in country X which is not a less developed country corporation within the meaning of section 902(d). Income tax of $2,500 ($25,000 × 10%) on such dividends is withheld at the source in country X. It is assumed that P is deemed under section 902(a)(1) and § 1.902-1(h) to have paid income tax of $22,500 to country X in respect of such dividends and that under paragraphs (a)(2)(i) and (b)(2)(i) of this section such dividends are deemed to be attributable to foreign mineral income from sources in country X and that such tax is deemed to be paid with respect to such foreign mineral income. Based upon the facts assumed, the U.S. tax on the foreign mineral income from sources in country X is $60,240 before allowance of the foreign tax credit, determined as follows:

Foreign mineral income from country X:		
Income from mining property	$100,000	
Dividends from R	25,000	
Sec. 78 dividend	22,500	$147,500
Less:		
Percentage depletion (14% of $100,000, but not to exceed 50% of $92,000)		$14,000
Other deductions		8,000
Taxable income		125,500
Income tax rate		48%
U.S. tax		60,240

(b) Without taking this section into account, P would be allowed a foreign tax credit for 1971 of $60,240

($60,240×$125,500/$125,500), and foreign income tax in the amount of $3,910 ([$39,150+$22,500+$2,500] less $60,240) would first be carried back to 1969 under section 904(d).

(c) Pursuant to paragraph (a)(1) of this section, however, the foreign income tax allowable as a credit against the U.S. tax is reduced from $64,150 to $60,240, determined as follows:

Foreign income tax paid, and deemed to be paid, to country X on foreign mineral income ($39,150+$22,500+$2,500)		$64,150
Less reduction under sec. 901(e):		
Smaller of $64,150 (tax paid and deemed paid to country X on foreign mineral income) or $64,560 (U.S. tax on foreign mineral income of $134,500 ($134,500×48%), determined by deducting cost depletion of $5,000 in lieu of percentage depletion of $14,000)	$64,150	
Less: U.S. tax on foreign mineral income (before credit)	$60,240	$3,910
Foreign income tax allowable as a credit		60,240

(d) After taking this section into account, P is allowed a foreign tax credit for 1971 of $60,240 ($60,240×$125,500/$125,500), but no foreign income tax is carried back to 1969 under section 904(d) since the allowable credit of $60,240 does not exceed the limitation of $60,240.

[T.D. 7294, 38 FR 33074, Nov. 30, 1973, as amended by T.D. 7481, 42 FR 20130, Apr. 18, 1977]

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation.

(a) *Definitions.* For purposes of section 902 and §§ 1.902–1 and 1.902–2.

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation after December 31, 1964, from a foreign corporation, the term "domestic shareholder" means a domestic corporation which owns at least 10 percent of the voting stock of the foreign corporation at the time it receives a dividend from such foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder after December 31, 1964, from a foreign corporation, the term "first-tier corporation" means a foreign corporation at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time it receives a dividend from such foreign corporation. The term "first-tier corporation" also means a DISC or former DISC, but only with respect to dividends from the DISC or former DISC to the extent they are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation.* (i) In the case of dividends paid to a first-tier corporation by a foreign corporation after January 12, 1971 (i.e., the date of enactment of Pub. L. 91-684, 84 Stat. 2068), but only for purposes of applying this section for a taxable year of a domestic shareholder ending after that date, the foreign corporation is a "second-tier corporation" if at least 10 percent of its voting stock is owned by the first-tier corporation at the time the first-tier corporation receives the dividend.

(ii) In the case of dividends paid to a first-tier corporation by a foreign corporation after January 12, 1971, but only for purposes of applying this section for a taxable year of a domestic shareholder ending before January 13, 1971, or in the case of any dividend paid to a first-tier corporation by a foreign corporation before January 13, 1971, the foreign corporation is a "second-tier corporation" if at least 50 percent of its voting stock is owned by the first-tier corporation at the time the first-tier corporation receives the dividend.

(4) *Third-tier corporation.* In the case of dividends paid to a second-tier corporation (as defined in paragraph (a)(3) (i) or (ii) of this section) by a foreign corporation after January 12, 1971, but only for purposes of applying this section for a taxable year of a domestic shareholder ending after that date, the foreign corporation is a "third-tier corporation" if at least 10 percent of its voting stock is owned by the second-tier corporation at the time the second-tier corporation receives the dividend.

(5) *Foreign income taxes.* The term "foreign income taxes" means income, war profits, and excess profits taxes, and taxes included in the term "income, war profits, and excess profits taxes" by reason of section 903, imposed by a foreign country or a possession of the United States.

(6) *Dividend.* For the definition of the term "dividend" for purposes of

applying section 902 and this section, see section 316 and the regulations thereunder.

(7) *Dividend received.* A dividend shall be considered received for purposes of section 902 and this section when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301-1(b).

(b) *Domestic shareholder owning stock in a first-tier corporation*—(1) *In general.* (i) If a domestic shareholder receives dividends in any taxable year from its first-tier corporation, the credit for foreign income taxes allowed by section 901 includes, subject to the conditions and limitations of this section, the foreign income taxes deemed, in accordance with paragraph (b)(2) of this section, to be paid by such domestic shareholder for such year.

(ii) If dividends are received by a domestic shareholder from more than one first-tier corporation, the taxes deemed to be paid by such shareholder under section 902(a) and this paragraph (b) shall be computed separately with respect to the dividends received from each of such first-tier corporations.

(iii) Any taxes deemed paid by a domestic shareholder for the taxable year pursuant to section 902(a) and paragraph (b)(2) of this section shall, except as provided in § 1.960-3(b), be included in the gross income of such shareholder for such year as a dividend pursuant to section 78 and § 1.78-1. For the source of such a section 78 dividend, see paragraph (h)(1) of this section.

(iv) Any taxes deemed, under paragraph (b)(2) of this section, to be paid by the domestic shareholder shall be deemed to be paid by such shareholder only for purposes of the foreign tax credit allowed under section 901. See section 904 for other limitations on the amount of the credit.

(v) For rules relating to reduction of the amount of foreign income taxes deemed paid or accrued with respect to foreign mineral income, see section 901(e) and § 1.901-3.

(vi) For the nonrecognition as a foreign income tax for purposes of this section of certain income, profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in such country, see section 901(f) and the regulations thereunder.

(vii) For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations thereunder.

(viii) See the regulations under sections 960, 962, and 963 for special rules relating to the application of section 902 in computing the foreign tax credit of United States shareholders of controlled foreign corporations.

(2) *Amount of foreign taxes deemed paid by a domestic shareholder.* To the extent dividends are paid by a first-tier corporation to its domestic shareholder out of accumulated profits, as defined in paragraph (e) of this section, for any taxable year, the domestic shareholder shall be deemed to have paid the same proportion of any foreign income taxes paid, accrued or deemed, in accordance with paragraph (c)(2) of this section, to be paid by such first-tier corporation on or with respect to such accumulated profits for such year which the amount of such dividends (determined without regard to the gross-up under section 78) bears to the amount by which such accumulated profits exceed the amount of such taxes (other than those deemed, under paragraph (c)(2) of this section, to be paid). For determining the amount of foreign income taxes paid or accrued by such first-tier corporation on or with respect to the accumulated profits for the taxable year of such first-tier corporation, see paragraph (f) of this section.

(c) *First-tier corporation owning stock in a second-tier corporation*—(1) *In general.* For purposes of applying section 902(a) and paragraph (b)(2) of this section, if a first-tier corporation receives dividends in any taxable year from its second-tier corporation, the foreign income taxes deemed to be paid by the first-tier corporation on or with respect to its own accumulated profits for such year shall be the amount determined in accordance with paragraph (c)(2) of this section. This paragraph (c) shall not apply unless the product of—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation at the time that the domestic shareholder receives dividends from the first-tier corporation in respect of which foreign income taxes are deemed to be paid by the domestic shareholder under paragraph (b)(1) of this section, and

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation

equals at least 5 percent. The percentage under paragraph (c)(1)(ii) of this section of voting stock owned by the first-tier corporation in the second-tier corporation is determined as of the time that the dividend distributed by the second-tier corporation is received by the first-tier corporation and thus included in accumulated profits of the first-tier corporation out of which dividends referred to in paragraph (c)(1)(i) of this section are distributed by the first-tier corporation to the domestic shareholder.

Example. On February 10, 1976, foreign corporation B pays a dividend out of its accumulated profits for 1975 to foreign corporation A. On February 16, 1976, the date on which it receives the dividend, A Corporation owns 40 percent of the voting stock of B Corporation. Both corporations use the calendar year as the taxable year. On June 1, 1976, A Corporation sells its stock in B Corporation. On January 17, 1977, A Corporation pays a dividend out of its accumulated profits for 1976 to domestic corporation M. M Corporation owns 30 percent of the voting stock of A Corporation on January 20, 1977, the date on which it receives the dividend. M Corporation uses a fiscal year ending on April 30 as the taxable year. On February 16, 1976, A Corporation satisfies the 10-percent stock ownership requirement referred to in paragraph (a)(3) of this section with respect to B Corporation, and on January 20, 1977, M Corporation satisfies the 10-percent stock-ownership requirement referred to in paragraph (a)(2) of this section with respect to A Corporation. The 5-percent requirement of this paragraph (c)(1) is also satisfied since 30 percent (the percentage of voting stock owned by M Corporation in A Corporation on January 20, 1977), when multiplied by 40 percent (the percentage of voting stock owned by A Corporation in B Corporation on February 16, 1976), equals 12 percent. Accordingly, for its taxable year ending on April 30, 1977, M Corporation is entitled to a credit for a portion of the foreign income taxes paid, accrued, or deemed to be paid, by A Corporation for 1976; and for 1976 A Corporation is deemed to have paid a portion of the foreign income taxes paid or accrued by B Corporation for 1975.

(2) *Amount of foreign taxes deemed paid by a first-tier corporation.* A first-tier corporation which receives dividends in any taxable year from its second-tier corporation shall be deemed to have paid for such year the same proportion of any foreign income taxes paid, accrued, or deemed, in accordance with paragraph (d)(2) of this section, to be paid by its second-tier corporation on or with respect to the accumulated profits, as defined in paragraph (e) of this section, for the taxable year of the second-tier corporation from which such dividends are paid which the amount of such dividends bears to the amount by which such accumulated profits of the second-tier corporation exceed the taxes so paid or accrued. For determining the amount of the foreign income taxes paid or accrued by such second-tier corporation on or with respect to the accumulated profits for the taxable year of such second-tier corporation, see paragraph (f) of this section.

(d) *Second-tier corporation owning stock in a third-tier corporation*—(1) *In general.* For purposes of applying section 902(b)(1) and paragraph (c)(2) of this section, if a second-tier corporation receives dividends in any taxable year from its third-tier corporation, the foreign income taxes deemed to be paid by the second-tier corporation on or with respect to its own accumulated profits for such year shall be the amount determined in accordance with paragraph (d)(2) of this section. This paragraph (d) shall not apply unless the product of—

(i) The percentage of voting stock arrived at in applying the 5-percent requirement of paragraph (c)(1) of this section with respect to dividends received by the first-tier corporation from the second-tier corporation, and

(ii) the percentage of voting stock owned by the second-tier corporation in the third-tier corporation equals at least 5 percent. The percentage under paragraph (d)(1)(ii) of this section of voting stock owned by the second-tier corporation in the third-tier corporation is determined as of the time that the dividend distributed by the third-tier corporation is received by the second-tier corporation and thus included in accumulated profits of the second-tier corporation out of which dividends referred to in paragraph (d)(1)(i) of this section are distributed by the second-tier corporation to the first-tier corporation.

Example. On February 27, 1975, foreign corporation C pays a dividend out of its accumulated profits for 1974 to foreign corporation B. On March 3, 1975, the date on which it receives the dividend, B Corporation owns 50 percent of the voting stock of C Corporation. On February 10, 1976, B Corporation pays a dividend out of its accumulated profits for 1975 to foreign corporation A. On February 16, 1976, the date on which it receives the dividend, A Corporation owns 40 percent of the voting stock of B Corporation. All three corporations use the calendar year as the taxable year. On January 17, 1977, A Corporation pays a dividend out of its accumulated profits for 1976 to domestic corporation M. M Corporation owns 30 percent of the voting stock of A Corporation on January 20, 1977, the date on which it receives the dividend. M Corporation uses a fiscal year ending on April 30 as the taxable year. On February 16, 1976, A Corporation satisfies the 10-percent stock ownership requirement referred to in paragraph (a)(3) of this section with respect to B Corporation, and on January 20, 1977, M Corporation satisfies the 10-percent stock-ownership requirement referred to in paragraph (a)(2) of this section with respect to A Corporation. The 5-percent requirement of paragraph (c)(1) of this section is also satisfied since 30 percent (the percentage of voting stock owned by M Corporation in A Corporation on January 20, 1977), when multiplied by 40 percent (the percentage of voting stock owned by A Corporation in B Corporation on February 16, 1976), equals 12 percent. On March 3, 1975, B Corporation satisfies the 10 percent stock ownership requirement referred to in paragraph (a)(4) of this section with respect to C Corporation. The 5-percent requirement of this paragraph (d)(1) is also satisfied since 12 percent (the percentage of voting stock arrived at in applying the 5-percent requirement of paragraph (c)(1) of this section with respect to the dividends received by A Corporation from B Corporation on February 16, 1976), when multiplied by 50 percent (the percentage of voting stock owned by B Corporation in C Corporation on March 3, 1975), equals 6 percent. Accordingly, for its taxable year ending on April 30, 1977, M Corporation is entitled to a credit for a portion of the foreign income taxes paid, accrued, or deemed to be paid, by A Corporation for 1976; for 1976 A Corporation is deemed to have paid a portion of the foreign income taxes paid, accrued, or deemed to be paid, by B Corporation for 1975; and for 1975 B Corporation is deemed to have paid a portion of the foreign income taxes paid or accrued by C Corporation for 1974.

(2) *Amount of foreign taxes deemed paid by a second-tier corporation.* For purposes of applying paragraph (c)(2) of this section to a first-tier corporation, a second-tier corporation which receives dividends in its taxable year from its third-tier corporation shall be deemed to have paid for such year the same proportion of any foreign income taxes paid or accrued by its third-tier corporation on or with respect to the accumulated profits, as defined in paragraph (e) of this section, for the taxable year of the third-tier corporation from which such dividends are paid which the amount of such dividends bears to the amount by which such accumulated profits of the third-tier corporation exceed the taxes so paid or accrued. For determining the amount of the foreign income taxes paid or accrued by such third-tier corporation on or with respect to the accumulated profits for the taxable year of such third-tier corporation, see paragraph (f) of this section.

(e) *Determination of accumulated profits of a foreign corporation.* The accumulated profits for any taxable year of a first-tier corporation and the accumulated profits for any taxable year of a second-tier or third-tier corporation, which are taken into account in applying paragraph (c)(2) or (d)(2) of this section with respect to such first-tier corporation, shall be the sum of—

(1) The earnings and profits of such corporation for such year, and

(2) The foreign income taxes imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable.

(f) *Taxes paid on or with respect to accumulated profits of a foreign corporation.* For purposes of this section, the amount of foreign income taxes paid or accrued on or with respect to the accumulated profits of a foreign corporation for any taxable year shall be the entire amount of the foreign income taxes paid or accrued for such year on or with respect to such gains, profits, and income. For purposes of this paragraph (f), the gains, profits, and income of a foreign corporation for any taxable year shall be determined after reduction by any income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, and income by the United States.

(g) *Determination of earning and profits of a foreign corporation*—(1) *Taxable year to which section 963 does not apply.* For purposes of this section, the earnings and profits of a foreign corporation for any taxable year beginning after December 31, 1962, other than a taxable year to which paragraph (g)(2) of this section applies, may, if the domestic shareholder chooses, be determined under the rules provided by § 1.964-1 exclusive of paragraphs (d) and (e) of such section. The translation of amounts so determined into United States dollars or other foreign currency shall be made at the proper exchange rate for the date of distribution with respect to which the determination is made.

(2) *Taxable year to which section 963 applies.* For any taxable year of a foreign corporation with respect to which there applies under § 1.963-1(c)(1) an election by a corporate United States shareholder to exclude from its gross income for the taxable year the subpart F income of a controlled foreign corporation, the earnings and profits of such foreign corporation for such year with respect to such shareholder must be determined, for purposes of this section, under the rules provided by § 1.964-1, even though the amount of the minimum distribution required under § 1.963-2(a) to be received by such shareholder from such earnings and profits of such foreign corporation, or from the consolidated earnings and profits of the chain or group which includes such foreign corporation, is zero. Effective for taxable years of foreign corporations beginning after December 31, 1975, section 963 is repealed by section 602(a)(1) of the Tax Reduction Act of 1975 (89 Stat. 58); accordingly, this paragraph (g)(2) is inapplicable with respect to computing earnings and profits for such taxable years.

(3) *Time and manner of making choice.* The controlling United States shareholders (as defined in § 1.964-1(c)(5)) of a foreign corporation shall make the choice referred to in paragraph (g)(1) of this section (including the elections permitted by § 1.964-1 (b) and (c)) by filing a written statement to such effect with the Director of the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155, within 180 days after the close of the first taxable year of the foreign corporation during which such shareholders receive a distribution of earnings and profits with respect to which the benefits of this section are claimed or on or before November 15, 1965, whichever is later. For purposes of this paragraph (g)(3), the 180-day period shall commence on the date of receipt of any distribution which is considered paid from the accumulated profits of a preceding year or years under paragraph (g)(4) of this section. See § 1.964-1(c)(3) (ii) and (iii) for procedures requiring notification of the Director of the Internal Revenue Service Center and noncontrolling shareholders of action taken.

(4) *Determination by district director.* The district director in whose district is filed the income tax return of the domestic shareholder claiming a credit under section 901 for foreign income taxes deemed, under section 902 and this section, to be paid by such shareholder shall have the power to determine, with respect to a foreign corporation, from the accumulated profits of what taxable year or years the dividends were paid. In making such determination the district director shall, unless it is otherwise established to his satisfaction, treat any dividends which are paid in the first 60 days of any taxable year of such a corporation as having been paid from the accumulated profits of the preceding taxable year or years of such corporation and shall, in other respects, treat any dividends as having been paid from the most recently accumulated profits. For purposes of this paragraph (g)(4), in the case of a foreign corporation the foreign income

taxes of which are determined on the basis of an accounting period of less than 1 year, the term "year" shall mean such accounting period. See sections 441 (b)(3) and 443.

(h) *Source of income from first-tier corporation and country to which tax is deemed paid*—(1) *Source of income.* For purposes of section 904(a)(1) (relating to the per-country limitation), in the case of a dividend received by a domestic shareholder from a first-tier corporation there shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which the first-tier corporation is created or organized the sum of the amounts which under paragraph (a)(3)(ii) of § 1.861-3 are treated, with respect to such dividend, as income from sources without the United States.

(2) *Country to which taxes deemed paid.* For purposes of section 904, all foreign income taxes paid, or deemed under paragraph (c) of this section to be paid, by a first-tier corporation shall be deemed to be paid to the foreign country or possession of the United States under the laws of which such first-tier corporation is created or organized.

(i) *United Kingdom income taxes paid with respect to royalties.* A taxpayer shall not be deemed under section 902 and this section to have paid any taxes with respect to which a credit is allowable to such taxpayer or any other taxpayer by virtue of section 905(b).

(j) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed, under paragraph (b)(2) of this section, to be paid, the domestic shareholder must furnish the same information with respect to such taxes as it is required to furnish with respect to the taxes actually paid or accrued by it and for which credit is claimed. See § 1.905-2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within such shareholder's taxable year, and for reduction in the amount of foreign income taxes paid or deemed to be paid for failure to furnish such information, see section 6038 and the regulations thereunder.

(k) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Throughout 1978, domestic corporation M owns all the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. Corporation A has accumulated profits, pays foreign income taxes, and pays dividends for 1978 as summarized below. For 1978, M Corporation is deemed, under paragraph (b)(2) of this section, to have paid $20 of the foreign income taxes paid by A Corporation for 1978 and includes such amount in gross income under section 78 as a dividend, determined as follows:

Gains, profits, and income of A Corp.	$100
Foreign income taxes imposed on or with respect to gains, profits, and income	40
Accumulated profits	100
Foreign income taxes paid on or with respect to accumulated profits (total foreign income taxes)	40
Accumulated profits in excess of foreign income taxes	60
Dividends paid to M Corp	30
Foreign income taxes of A Corp. deemed paid by M Corp. under sec. 902(a) ($40×$30/$60)	20

Example (2). The facts are the same as in example (1), except that M Corporation also owns all the one class of stock of foreign corporation B which also uses the calendar year as the taxable year. Corporation B has accumulated profits, pays foreign income taxes, and pays dividends for 1978 as summarized below. For 1978, M Corporation is deemed under paragraph (b)(2) of this section, to have paid $20 of the foreign income taxes paid by A Corporation for 1978 and to have paid $50 of the foreign income taxes paid by B Corporation for 1978, and includes $70 in gross income as a dividend under section 78, determined as follows:

B CORPORATION

Gains, profits and income	$200
Foreign income taxes imposed on or with respect to gains, profits, and income	100
Accumulated profits	200
Foreign income taxes paid by B Corp. on or with respect to accumulated profits	100
Accumulated profits in excess of foreign income taxes	100
Dividends paid to M Corp	50
Foreign income taxes of B Corporation deemed paid by M Corporation under section 902(a) ($100×$50/$100)	50

M CORPORATION

Foreign income taxes deemed paid under sec. 902(a):	
Taxes of A Corp. (from example (1))	$20

M CORPORATION—Continued

Taxes of B Corp. (as determined above)	50
Total	70
Foreign income taxes included in gross income under sec. 78 as a dividend:	
Taxes of A Corp. (from example (1))	20
Taxes of B Corp.	50
Total	70

Example (*3*). For 1978, domestic corporation M owns all the one class of stock of foreign corporation A, which in turn owns all the one class of stock of foreign corporation B. All corporations use the calendar year as the taxable year. For 1978, M Corporation is deemed under paragraph (b)(2) of this section to have paid $50 of the foreign income taxes paid, or deemed under paragraph (c)(2) of this section to be paid, by A Corporation for such year and includes such amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

B Corp. (second-tier corporation):	
Gains, profits, and income	$300
Foreign income taxes imposed on or with respect to gains, profits, and income	120
Accumulated profits	300
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (total foreign income taxes)	120
Accumulated profits in excess of foreign income taxes	180
Dividends paid on Dec. 31, 1978 to A Corp.	90
Foreign income taxes of B Corp. deemed paid by A Corp. for 1978 under sec. 902(b)(1) ($120×$90/$180)	60
A Corp. (first-tier corporation):	
Gains, profits, and income:	
Business operations	200
Dividends from B Corp.	90
Total	290
Foreign income taxes imposed on or with respect to gains, profits, and income	40
Accumulated profits	$290
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	40
Accumulated profits in excess of foreign income taxes	250
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1978 on or with respect to its accumulated profits for such year ($60+$40)	100
Dividends paid on Dec. 31, 1978, to M Corp.	125
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. deemed paid by M Corp. for 1978 under sec. 902(a) ($100×$125/$250)	50
Foreign income taxes included in gross income of M Corp. under sec. 78 as a dividend received from A Corp.	50

Example (*4*). Throughout 1978, domestic corporation M owns 50 percent of the voting stock of foreign corporation A, not a less developed country corporation. A Corporation has owned 40 percent of the voting stock of foreign corporation B, since 1970; B Corporation has owned 30 percent of the voting stock of foreign corporation C, since 1972. B Corporation, uses a fiscal year ending on June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1977, B Corporation receives a dividend from C Corporation out of C Corporation's accumulated profits for 1976. On February 15, 1977, A Corporation receives a dividend from B Corporation out of B Corporation's accumulated profits for its fiscal year ending in 1977. On February 15, 1978, M Corporation receives a dividend from A Corporation out of A Corporation's accumulated profits for 1977. For 1978, M Corporation is deemed under paragraph (b)(2) of this section to have paid $81.67 of the foreign income taxes paid, or deemed under paragraph (c)(2) of this section to be paid, by A Corporation on or with respect to its accumulated profits for 1977, and M Corporation includes that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

C Corp. (third-tier corporation):	
Gains, profits, and income for 1976	$2,000.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	800.00
Accumulated profits	2,000.00
Foreign income taxes paid by C Corp. on or with respect to its accumulated profits (total foreign income taxes)	800.00
Accumulated profits in excess of foreign income taxes	1,200.00
Dividends paid on Feb. 1, 1977 to B Corp	150.00
Foreign income taxes of C Corp. for 1976 deemed paid by B Corp. for its fiscal year ending in 1977 ($800×$150/$1,200)	100.00
B Corp. (second-tier corporation):	
Gains, profits, and income for fiscal year ending in 1977:	
Business operations	850.00
Dividends from C Corp	150.00
Total	1,000.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00
Accumulated profits	1,000.00
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (total foreign income taxes)	$200.00
Accumulated profits in excess of foreign income taxes	800.00
Foreign income taxes paid, and deemed to be paid, by B Corp. for its fiscal year on or with respect to its accumulated profits for such year ($100+$200)	300.00
Dividends paid on Feb. 15, 1977 to A Corp	120.00
Foreign income taxes of B Corp. for its fiscal year deemed paid by A Corp. for 1977 ($300×$120/$800)	45.00
A Corp. (first-tier corporation):	
Gains, profits, and income for 1977:	
Business operations	380.00
Dividends from B Corp	120.00
Total	500.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00

Accumulated profits	500.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	200.00
Accumulated profits in excess of foreign taxes	300.00
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1977 on or with respect to its accumulated profits for such year ($45+$200)	245.00
Dividends paid on Feb. 15, 1978 to M Corp	100.00
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. for 1977 deemed paid by M Corp. for 1978 under sec. 902(a)(1) ($245×$100/$300)	81.67
Foreign income taxes included in gross income of M Corp. under sec. 78 as a dividend received from A Corp	81.67

Effective date. This section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964. For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see 26 CFR 1.902-5 (Rev. as of April 1, 1976).

[T.D. 7481, 42 FR 20125, Apr. 18, 1977, as amended by T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.902-2 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) *In general.* If a domestic shareholder receives a distribution from a first-tier corporation before January 1, 1978, in a taxable year of the domestic shareholder beginning after December 31, 1964, which is attributable to accumulated profits of the first-tier corporation for a taxable year beginning before January 1, 1976, in which the first-tier corporation was a less developed country corporation (as defined in 26 CFR § 1.902-2 rev. as of April 1, 1978), then the amount of the credit deemed paid by the domestic shareholder with respect to such distribution shall be calculated under the rules relating to less developed country corporations contained in (26 CFR § 1.902-1 rev. as of April 1, 1978).

(b) *Combined distributions.* If a domestic shareholder receives a distribution before January 1, 1978, from a first-tier corporation, a portion of which is described in paragraph (a) of this section, and a portion of which is attributable to accumulated profits of the first-tier corporation for a year in which the first-tier corporation was not a less developed country corporation, then the amount of taxes deemed paid by the domestic shareholder shall be computed separately on each portion of the dividend. The taxes deemed paid on that portion of the dividend described in paragraph (a) shall be computed as specified in paragraph (a). The taxes deemed paid on that portion of the dividend described in this paragraph (b), shall be computed as specified in § 1.902-1.

(c) *Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.* Paragraph (a) shall apply to a distribution received by a domestic shareholder before January 1, 1978, from a first-tier corporation out of accumulated profits for a taxable year beginning after December 31, 1975, if:

(1) The distribution is attributable to a distribution received by the first-tier corporation from a second- or third-tier corporation in a taxable year beginning after December 31, 1975.

(2) The distribution from the second- or third-tier corporation is made out of accumulated profits of the second- or third-tier corporation for a taxable year beginning before January 1, 1976, and

(3) The first-tier corporation would have qualified as a less developed country corporation under section 902(d) (as in effect on December 31, 1975), in the taxable year in which it received the distribution.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). M, a domestic corporation owns all of the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. A Corporation pays a dividend to M Corporation on January 1, 1977, partly out of its accumulated profits for calendar year 1976 and partly out of its accumulated profits for calendar year 1975. For 1975 A Corporation qualified as a less developed country corporation under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (a) and (b) of this section to have paid $63 of foreign income taxes paid by A Corporation on or with respect to its accumulated profits for 1976 and 1975 and M Corporation includes $36 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

1976

Gains, profits, and income of A Corp. for 1976	$120.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	36.00
Accumulated profits	120.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	36.00
Accumulated profits in excess of foreign income taxes	84.00
Dividend to M Corp. out of 1976 accumulated profits	84.00
Foreign income taxes of A for 1976 deemed paid by M Corp. ($84/$84×$36)	36.00
Foreign income taxes included in gross income of M Corp. under sec. 78 as a dividend from A Corp	36.00

1975

Gains, profits, and income of A Corp. for 1975	$257.14
Foreign income taxes imposed on or with respect to such gains, profits, and income	77.14
Accumulated profits (under sec. 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	180.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits ($77.14×$180/$257.14)	54.00
Dividend to M Corp. out of accumulated profits of A Corp. for 1975	90.00
Foreign income taxes of A Corp. for 1975 deemed paid by M Corp. (under sec. 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($54×$90/$180)	27.00
Foreign income taxes included in gross income of M Corp. under sec. 78 as a dividend from A Corp	0

Example (2) The facts are the same as in example (1), except that the distribution from A Corporation to M Corporation on January 1, 1977, was from accumulated profits of A Corporation for 1976. A Corporation's accumulated profits for 1976 were made up of income from its trade or business, and a dividend paid by B, a second-tier corporation in 1976. The dividend from B Corporation to A Corporation was from accumulated profits of B Corporation for 1975. A Corporation would have qualified as a less developed country corporation for 1976 under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (b) and (c) of this section to have paid $543 of the foreign taxes paid or deemed paid by A Corporation on or with respect to its accumulated profits for 1976, and M Corporation includes $360 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

Total gains, profits, and income of A Corp. for 1976	$1,500
Gains and profits from business operations	1,200
Gains and profits from dividend A Corp. received in 1976 from B Corp. out of accumulated profits of B Corp. for 1975	300
Foreign taxes imposed on or with respect to such profits and income	450
Foreign taxes paid by A Corp. attributable to gains and profits from A Corp.'s business operations	360
Foreign taxes paid by A Corp. attributable to dividend from B Corp. in 1976	90
Dividends from A Corp. to M Corp. on Jan. 1, 1977	1,050
Portion of dividend attributable to gains and profits of A Corp. from business operations. ($1,200/$1,500×$1,050)	840
Portion of dividends attributable to gains on profits of A Corp. from dividend from B Corp. ($300/$1,500×$1,050)	210

(a) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on A Corp.'s gains and profits for 1976 from business operations.*

Gains, profits, and income of A Corp. from business operations	$1,200
Foreign income taxes imposed on or with respect to gains, profits, and income	360
Accumulated profits	1,200
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	360
Accumulated profits in excess of foreign income taxes	840
Dividend to M Corp	840
Foreign taxes of A Corp. deemed paid by M Corp. ($360 × $840/$840)	360
Foreign taxes included in gross income of M Corp. under sec. 78 as a dividend	360

(b) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on portion of the dividend attributable to B Corp.'s accumulated profits for 1975.*

B Corp. (second-tier corporation):	
Gains, profits, and income for calendar year 1975	$1,000
Foreign income taxes imposed on or with respect to gains, profits, and income	400
Accumulated profits (under sec. 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	600
Foreign income taxes paid by B Corp. on or with respect to its accumulated profits ($400 × $600/$1,000)	240
Dividend to A Corp. in 1976	300
Foreign taxes of B Corp. for 1975 deemed paid by A Corp. (under sec. 902(b)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976) ($240 × $300/$600)	120

A Corp. (first-tier corporation):	
Gains, profits, and income for 1976 attributable to dividend from B Corp.'s accumulated profits for 1975	300
Foreign income taxes imposed on or with respect to such gains, profits, and income	90
Accumulated profits (under sec. 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	210
Foreign taxes paid by A Corp. on or with respect to such accumulated profits ($90 × $210/$300)	63
Foreign income taxes paid and deemed to be paid by A Corp. for 1976 on or with respect to such accumulated profits ($120 + $63)	183
Dividend paid to M Corp. attributable to dividend from B Corp. out of accumulated profits for 1975)	210
Foreign taxes of A Corp. deemed paid by M Corp. (under sec. 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($183 × $210/$210)	183
Amount included in gross income of M Corp. under sec. 78	0

[T.D. 7649, 44 FR 60087, Oct. 18, 1979]

§ 1.904-1 Limitation on credit for foreign taxes.

(a) *Per-country limitation*—(1) *General.* In the case of any taxpayer who does not elect the overall limitation under section 904(a)(2), the amount allowable as a credit for income or profits taxes paid or accrued to a foreign country or a possession of the United States is subject to the per-country limitation prescribed in section 904(a)(1). Such limitation provides that the credit for such taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904 (d)) to each foreign country or possession of the United States shall not exceed that proportion of the tax against which credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For special rules regarding the application of the per-country limitation when the taxpayer has derived section 904(f) interest or section 904(f) dividends, see § 1.904-4 or § 1.904-5.

(2) *Illustration of principles.* The operation of the per-country limitation under section 904(a)(1) on the credit for foreign taxes paid or accrued may be illustrated by the following examples:

Example (1). The credit for foreign taxes allowable for 1954 in the case of X, an unmarried citizen of the United States who in 1954 received the income shown below and had three exemptions under section 151, is $14,904, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	25,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	16,000
Per-country limitation (25,000/75,000 of $44,712)	14,904
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the per-country limitation)	14,904

Example (2). Assume the same facts as in example (1), except that the sources of X's income and taxes paid are as shown below. The credit for foreign taxes allowable to X is $13,442.40, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	15,000
Taxable income (computed without deductions for personal exemptions) from sources within Canada	10,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	10,800
Per-country limitation on British income and profits taxes (15,000/75,000 of $44,712)	8,942.40
Credit for British income and profits taxes as limited by per-country limitation	8,942.40
Canadian income and profits taxes	4,500.00
Per-country limitation on Canadian income and profits taxes (10,000/75,000 of $44,712	5,961.60
Credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount does not exceed the per-country limitation)	4,500.00
Total amount of credit allowable (sum of credits—$8,942.40 plus $4,500)	18,442.40

Example (3). A domestic corporation realized taxable income in 1954 in the amount of $100,000, consisting of $50,000 from United States sources and dividends of $50,000 from a Brazilian corporation, more than 10 percent of whose voting stock it owned. The Brazilian corporation paid income and profits taxes to Brazil on its income and in addition paid a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source. The domestic corporation's credit for foreign taxes is $23,250, computed as follows:

Taxable income from sources within the United States		$50,000
Taxable income from sources within Brazil		50,000
Total taxable income		100,000
United States income tax		46,500
Dividend tax paid at source to Brazil		19,000
Income and profits taxes deemed under section 902 to have been paid to Brazil, computed as follows:		
Dividends received from Brazilian corporation during 1954	$50,000	
Income of Brazilian corporation during 1954	200,000	
Income and profits taxes paid to Brazil on $200,000	30,000	
Accumulated profits ($200,000 minus $30,000)	170,000	
Brazilian taxes applicable to accumulated profits distributed:		
50,000/170,000 of 170,000/200,000 of $30,000		7,500
Total income and profits taxes paid and deemed to have been paid to Brazil		26,500
Per-country limitation (50,000/100,000 of $46,500)		23,250
Credit for Brazilian income and profits taxes as limited by per-country limitation		23,250

(b) *Overall limitation*—(1) *General.* In the case of any taxpayer who elects the overall limitation provided by section 904(a)(2), the total credit for taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) shall not exceed that proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. For special rules regarding the application of the overall limitation when the taxpayer has derived section 904(f) interest or section 904(f) dividends, see § 1.904-4 or § 1.904-5.

(2) *Illustration of principles.* The operation of the overall limitation under section 904(a)(2) may be illustrated by the following example:

Example. Corporation X, a domestic corporation, for its taxable year beginning January 1, 1961, elects the overall limitation provided by section 904(a)(2). For taxable year 1961 corporation X has taxable income of $275,000 of which $200,000 is from sources without the United States. The United States income tax is $137,500. During the taxable year corporation X pays or accrues to foreign countries $105,000 in income and profits taxes, consisting of $45,000 paid or accrued to foreign country Y and $60,000 to foreign country Z. The credit for such foreign taxes is limited to $100,000, i.e., 200,000 ÷ 275,000 × $137,500. The limitation would be the same whether or not some portion of the $200,000 of the taxable income from sources without the United States is from sources on the high seas or in a foreign country (other than Y and Z) which imposed no taxes allowable as a credit.

(c) *Special computation of taxable income.* For purposes of computing the limitations under paragraphs (a) and (b) of this section, the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642(b).

(d) *Election of overall limitation*—(1) *In general*—(i) *Manner of making election.* The initial election under section 904(b) of the overall limitation provided by section 904(a)(2) may be made by the taxpayer for any taxable year beginning after December 31, 1960, without securing the consent of the Commissioner. The taxpayer may, for the first taxable year for which the election is to be made, make such election at any time before the expiration of the period referred to in paragraph (d) of § 1.901-1 for choosing the benefits of section 901 for such taxable year. Having made the initial election, the taxpayer may, within the time prescribed for making such election for such taxable year, revoke such election without the consent of the Commissioner. If such revocation is timely and properly made, the taxpayer may make his initial election of the overall limitation for a later taxable year without the consent of the Commissioner. If, however, the taxpayer makes the initial election for a taxable year and the period prescribed for making such election for such taxable year expires, the taxpayer must continue the election of the overall limitation for all subsequent taxable years (whether or not foreign taxes were paid or accrued for any such year and notwithstanding that a deduction for foreign taxes under section 164 was claimed for any such year) until revoked with the consent of the Commissioner. See section 904(b)(1). If the election for any taxable year is revoked with the consent of the Commissioner, the taxpayer may not make a new election for such taxable year or for any subsequent taxable year without the consent of the Commissioner. If the election of the overall limitation is revoked for a taxable year, the per-country limitation shall apply to such taxable year and to all taxable years thereafter unless a new election of the overall limitation is made, either with or without the consent of the Commissioner in accordance with this section.

(ii) *Revocation for first taxable year beginning after December 31, 1969.* Notwithstanding subdivision (i) of this subparagraph, if the taxpayer has made an initial election under section 904(b) of the overall limitation for a taxable year beginning before January 1, 1970, and the period prescribed for making such election for such taxable year has expired, or if he has made a new election for such a taxable year with the consent of the Commissioner, he may revoke such election effective with respect to his first taxable year beginning after December 31, 1969, without the consent of the Commissioner. Such revocation may be made within the time prescribed for making an initial election for such first taxable year beginning after December 31, 1969. If such revocation is timely and properly made, the taxpayer may make a new election of the overall limitation for a later taxable year without the consent of the Commissioner. Such new election for a later taxable year may be made at any time before the expiration of the period referred to in paragraph (d) of § 1.901-1 for choosing the benefits of section 901 for such taxable year. The revocation of an election, or the making of a new election, pursuant to this subdivision shall be made in the same manner provided in subparagraph (2) of this paragraph for revoking or making an initial election. This subdivision applies even though the taxpayer is not required under section 901(e) and § 1.901-3 to reduce the amount of any foreign taxes paid, accrued, or deemed to be paid with respect to foreign mineral income for any taxable year beginning after December 31, 1969.

(2) *Method of making the initial election.* The initial election of the overall limitation under section 904(b) shall be made on Form 1116 in the case of an individual or on Form 1118 in the case of a corporation. The form shall be attached to the appropriate income tax return for the taxable year to which such election applies. Such election may be made, however, only for a taxable year for which the taxpayer chooses to claim a credit under section 901. If the taxpayer revokes the initial election without the consent of the Commissioner, he must file amended Form 1116 or 1118 and amended income tax returns or claims for refund, where applicable, for the taxable years to which the revocation applies. For rules relating to the filing of such forms, see paragraph (a) of § 1.905-2.

(3) *Method of revoking an election and making a new election.* A request to revoke an election of the overall limitation under section 904(b) when such revocation requires the consent of the Commissioner, or to make a new election when such election requires the consent of the Commissioner, shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Washington, D.C., 20224. The request shall include the name and address of the taxpayer and shall be signed by the taxpayer or his duly authorized representative. It must specify the taxable year for which the revocation or new election is to be effective and shall be mailed within 75 days after the close of the first taxable year for which it is desired to make the change. It must be accompanied by a statement specifying the nature of the taxpayer's business, the countries in which the business is carried on, or expected to be carried on, within the taxable year of the requested change, and grounds considered as justifying the requested revocation or new election. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Generally, a request for consent to revoke an election or make a new election will be granted if the basic nature of the taxpayer's business changes or if there are changes in conditions in a foreign country which substantially affect the taxpayer's busi-

ness. For example, a taxpayer who enters substantial operations in a new foreign country or who loses an existing investment due to nationalization, expropriation, or war would be granted consent to revoke an election or make a new election.

(e) *Joint return*—(1) *General.* In the case of a husband and wife making a joint return, the applicable limitation prescribed by section 904(a) on the credit for taxes paid or accrued to foreign countries and possessions of the United States shall be applied with respect to the aggregate taxable income from sources within each such country or possession, or from sources without the United States, as the case may be, and the aggregate taxable income from all sources, of the spouses.

(2) *Electing the overall limitation.* If a husband and wife make a joint return for the current taxable year, but made a separate return for the preceding taxable year and the overall limitation applied for such preceding taxable year to one spouse or to both spouses (whether or not then married), then, unless revoked with the consent of the Commissioner, the overall limitation shall apply for the current taxable year and for subsequent taxable years of both spouses, whether or not they remain married, whether or not joint returns are filed for such subsequent taxable years, and whether or not one of such spouses could have elected the overall limitation for the current taxable year only with the consent of the Commissioner if he had filed a separate return for such year.

[T.D. 6789, 29 FR 19243, Dec. 31, 1964, as amended by T.D. 7294, 38 FR 33080, Nov. 30, 1973; T.D. 7292, 38 FR 33291, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977; 42 FR 32536, June 27, 1977]

§ 1.904-2 Carryback and carryover of unused foreign tax.

(a) *Credit for foreign tax carryback or carryover.* A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(d). However, the taxes so deemed paid or accrued shall not be allowed as a deduction under section 164(a). The following paragraphs of this section provide rules for the computation of carryovers and carrybacks under section 904(d). For special rules regarding the application of section 904(d) and this section in the case of taxes paid or accrued with respect to section 904(f) interest see section 904(f) and § 1.904-4. For special rules regarding the application of section 904(d) and this section in the case of taxes paid, accrued, or deemed to be paid with respect to section 904(f) dividends see section 904(f) and § 1.904-5.

(b) *Years to which carried*—(1) *General.* If the taxpayer chooses the benefits of section 901 for a taxable year beginning after December 31, 1957, any unused foreign tax (as defined in subparagraph (2) of this paragraph) for such year shall, under section 904(d), be carried to the second preceding taxable year, the first preceding taxable year, and the first, second, third, fourth, and fifth succeeding taxable years, in that order and to the extent not absorbed as taxes deemed paid or accrued, under paragraph (c) of this section, in a prior taxable year. The entire unused foreign tax for any taxable year shall first be carried to the earliest of the taxable years to which, under the preceding sentence, such unused foreign tax may be carried. Any portion of such unused foreign tax not deemed paid or accrued under paragraph (c) of this section in such earliest taxable year shall then be carried to the next earliest taxable year to which such unused foreign tax may be carried, and any portion not absorbed in that year shall then be carried to the next earliest year, and so on.

(2) *Definitions.* (i) When used with reference to a taxable year for which the per-country limitation provided in section 904(a)(1) applies, the term "unused foreign tax" means, with respect to a particular foreign country or possession of the United States, the excess of (*a*) the income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) in such year to such foreign country

or possession, over (*b*) the applicable per-country limitation under section 904(a)(1) for such year.

(ii) When used with reference to a taxable year for which the overall limitation provided in section 904(a)(2) applies, the term "unused foreign tax" means the excess of (*a*) the income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) in such year to all foreign countries and possessions of the United States, over (*b*) the overall limitation under section 904(a)(2) for such year.

(iii) The term "unused foreign tax" does not include any amount by which the income, war profits, and excess profits taxes paid or accrued, or deemed to be paid, to any foreign country or possession of the United States with respect to foreign mineral income are reduced under section 901(e)(1) and § 1.901-3(b)(1).

(3) *Taxable years beginning before January 1, 1958.* For purposes of this paragraph, the terms "second preceding taxable year" and "first preceding taxable year" do not include any taxable year beginning before January 1, 1958.

(c) *Tax deemed paid or accrued*—(1) *Unused foreign tax for per-country limitation year.* (i) The amount of an unused foreign tax with respect to a particular foreign country or possession of the United States, for a taxable year for which the per-country limitation under section 904(a)(1) applies, which shall be deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section shall, except as provided in subdivision (iii) of this subparagraph, be equal to the smaller of—

(*a*) The portion of such unused foreign tax which, under paragraph (b) of this section, is carried to such taxable year, or

(*b*) Any excess limitation for such taxable year with respect to such unused foreign tax (as determined under subdivision (ii) of this subparagraph).

(ii) The excess limitation for any taxable year (hereinafter called the "excess limitation year") with respect to an unused foreign tax in respect of a particular foreign country or possession of the United States for another taxable year (hereinafter called the "year of origin") shall be the amount, if any, by which the limitation for the excess limitation year with respect to that foreign country or possession (computed under section 904(a)(1)) exceeds the sum of—

(*a*) The income, war profits, and excess profits taxes actually paid or accrued to such foreign country or possession in the excess limitation year,

(*b*) The income, war profits, and excess profits taxes deemed paid or accrued in such year to such foreign country or possession other than by reason of section 904(d), and

(*c*) The portion of the unused foreign tax, with respect to such foreign country or possession for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under subdivision (i) of this subparagraph.

(iii) An unused foreign tax for a taxable year for which the per-country limitation provided in section 904(a)(1) applies shall not be deemed paid or accrued in a taxable year for which the overall limitation provided in section 904(a)(2) applies, notwithstanding that under paragraph (b) of this section such overall limitation year is counted as one of the years to which such unused foreign tax may be carried.

(iv) Any portion of an unused foreign tax with respect to a particular foreign country or possession of the United States which is deemed paid or accrued under section 904(d) in the year to which it is carried shall be deemed paid or accrued to the same foreign country or possession to which such foreign tax was paid or accrued (or deemed paid or accrued other than by reason of section 904(d)) for the year in which it originated.

(v) For determination of excess limitation for a year for which the taxpayer does not choose to claim a credit under section 901, see paragraph (d) of this section.

(2) *Unused foreign tax for overall limitation year.* (i) The amount of an

unused foreign tax with respect to all foreign countries and possessions of the United States, for a taxable year for which the overall limitation provided in section 904(a)(2) applies, which shall be deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section shall, except as provided in subdivision (iii) of this subparagraph, be equal to the smaller of—

(*a*) The portion of such unused foreign tax which, under paragraph (b) of this section is carried to such taxable year, or

(*b*) Any excess limitation for such taxable year with respect to such unused foreign tax (as determined under subdivision (ii) of this subparagraph).

(ii) The excess limitation for any taxable year (hereinafter called the "excess limitation year") with respect to an unused foreign tax in respect of all foreign countries and possessions of the United States for another taxable year (hereinafter called the "year of origin") shall be the amount, if any, by which the limitation for the excess limitation year with respect to all foreign countries and possessions of the United States (computed under section 904(a)(2)) exceeds the sum of—

(*a*) The income, war profits, and excess profits taxes actually paid or accrued to all foreign countries and possessions in the excess limitation year,

(*b*) The income, war profits, and excess profits taxes deemed paid or accrued in such year to all foreign countries and possessions other than by reason of section 904(d), and

(*c*) The portion of the unused foreign tax, with respect to all foreign countries and possessions for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under subdivision (i) of this subparagraph.

(iii) An unused foreign tax for a taxable year for which the overall limitation provided in section 904(a)(2) applies shall not be deemed paid or accrued in a taxable year for which the per-country limitation provided in section 904(a)(1) applies, notwithstanding that under paragraph (b) of this section such per-country limitation year is counted as one of the years to which such unused foreign tax may be carried.

(iv) For determination of excess limitation for a year for which the taxpayer does not choose to claim a credit under section 901, see paragraph (d) of this section.

(3) *Unused foreign tax with respect to foreign mineral income.* If any portion of an unused foreign tax for any taxable year beginning after December 31, 1969, consists of tax paid or accrued, or deemed to be paid, with respect to foreign mineral income, as defined in § 1.901-3(c), such portion shall not be deemed paid or accrued with respect to foreign mineral income in the taxable year to which it is carried under section 904(d).

(d) *Determination of excess limitation for certain years.* An excess limitation for a taxable year may exist, and may absorb all or some portion of an unused foreign tax, even though the taxpayer does not choose to claim a credit under section 901 for such year. In such case, the amount of the excess limitation, if any, for such year (hereinafter called the "deduction year") shall be determined in the same manner as though the taxpayer had chosen to claim a credit under section 901 for that year. For purposes of the preceding sentence—

(1) If the taxpayer has not chosen the benefits of section 901 for any taxable year before the deduction year, the per-country limitation under section 904 (a)(1) shall be considered to be applicable for such year, and

(2) If the taxpayer has chosen the benefits of section 901 for any taxable year before the deduction year, the limitation (per-country or overall) applicable for the last taxable year (preceding such deduction year for) which a credit was claimed under section 901 shall be considered to be applicable for such deduction year.

(e) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 904(d) the years to which the unused foreign tax may be carried, and any unused foreign tax or excess limitation for such fractional part of a year is the unused foreign tax or excess limitation for a taxable year.

(f) *Statement with tax return.* Every taxpayer claiming the benefit of a carryback or carryover of the unused foreign tax to any taxable year for which he chooses to claim a credit under section 901 shall file with his return (or with his claim for refund, if appropriate) for that year as an attachment to his Form 1116 or 1118, as the case may be, a statement setting forth the unused foreign tax deemed paid or accrued under this section and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the unused foreign tax so carried back or over.

(g) *Illustration of carrybacks and carryovers.* The application of this section may be illustrated by the following examples:

Example (1). (i) A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, chooses to claim a credit under section 901 for each of the taxable years set forth below. Based upon the taxes actually paid to country X, and the section 904(a)(1) limitation applicable in respect of country X, in each of the taxable years, the unused foreign tax deemed paid under section 904(d) in each of the appropriate taxable years is as follows:

	Taxable years								
	1958	1959	1960	1961	1962	1963	1964	1965	1966
Per-country limitation	$175	$150	$100	$100	$100	$300	$400	$200	$600
Taxes actually paid to country X in taxable year	75	60	830	170	150	100	200	140	400
Unused foreign tax to be carried back or over from year of origin	....	....	730	70	50	....	....	....	....
Excess limitation with respect to unused foreign tax for—									
1960	(100)	(90)	....	....	....	(200)	(200)	(60)	....
1961	....	....	....	....	....	....	....	....	(200)
1962	....	....	....	....	....	....	....	....	(130)
Unused foreign tax absorbed as taxes deemed paid under the carryback and carryover provisions as carried from—									
1960	100	90	....	....	....	200	200	60	....
1961	....	....	....	....	....	....	....	....	70
1962	....	....	....	....	....	....	....	....	50

(ii) The excess limitation for 1958, 1959, 1963, 1964, and 1965, respectively, which is available to absorb the unused foreign tax for 1960 is the amount by which the per-country limitation for each of those years exceeds the taxes actually paid to country X in each such year. The unused foreign tax for 1961 and 1962 are not taken into account, since neither of those years is a year earlier than 1960, the year of origin in respect of which the excess limitation is being determined. Thus, for example, the excess limitation for 1963 is $200, unreduced by the unused foreign tax for 1961 and 1962. There is no excess limitation for 1966 with respect to the unused foreign tax for 1960, since the unused foreign tax may be carried forward only 5 taxable years. The unused foreign tax ($730) for 1960 is thus absorbed as taxes deemed paid to the extent of the excess limitation for each of the taxable years 1958, 1959, 1963, 1964, and 1965, respectively, and in that order, leaving unused foreign tax in the amount of $80 which cannot be absorbed because it cannot be carried beyond 1965.

(iii) The amount of unused foreign tax for 1961 which is deemed paid in 1966 is $70, the smaller of (*a*) that portion of the unused foreign tax carried to 1966 ($70), or (*b*) the excess limitation for 1966 with respect to such unused foreign tax ($200). The unused foreign tax for 1962 ($50) is not taken into account for such purposes, since that year is not a year earlier than 1961, the year of origin in respect of which the excess limitation for 1966 is being determined.

(iv) The excess limitation for 1966 with respect to the unused foreign tax for 1962 is $130, the amount by which the limitation applicable under section 904(a)(1) for 1966 ($600) exceeds the sum of the taxes actually paid ($400) to country X in that year and the unused foreign tax ($70) for 1961 which is absorbed in 1966 as taxes deemed paid and which is carried from a taxable year earlier than 1962, the year of origin in respect of which the excess limitation is being determined. The unabsorbed part ($80) of the unused foreign tax for 1960, a year earlier than 1962, is not taken into account in computing the excess limitation for 1966, since the unused foreign tax for 1960 may not be carried beyond 1965. The unused foreign tax ($50) for 1962 is thus absorbed in full in 1966 as taxes deemed paid, since the unused foreign tax does not exceed the excess limitation ($130) for that year.

Example (2). Assume the same facts as those in example (1) except that the taxpayer does not choose to have the benefits of section 901 for 1961. In that case there is no unused foreign tax for that year to carry back or over to be absorbed in other taxable years as taxes deemed paid. Moreover, the excess limitation for 1966 which is available to absorb the unused foreign tax for 1962 is $200, instead of $130, that is, the amount by which the limitation applicable under section 904(a)(1) for 1966 ($600) exceeds the taxes actually paid ($400) to country **X** in that year. The amount of the unused foreign tax absorbed in each taxable year as taxes deemed paid is the same as in example (1) except for 1966. In that year only the unused foreign tax ($50) for 1962 is absorbed as taxes deemed paid.

Example (3). Assume the same facts as those in example (1) except that the taxpayer does not choose the benefits of section 901 for 1959. Since the excess limitation for a taxable year for which the taxpayer does not claim a credit under section 901 is determined in the same manner as though the taxpayer had chosen such credit, the excess limitation for 1959 is determined to be $90 just as in example (1). Moreover, even though such excess limitation absorbs a carryback of $90 from the unused tax for 1960, none of such $90 so deemed paid in 1959 is allowed as a deduction under section 164 or as a credit under section 901 for 1959 or for any other taxable year.

Example (4). (i) B, a calendar year taxpayer using the cash receipts and disbursements methods of accounting, chooses the benefits of section 901 for each of the taxable years 1957, 1958, and 1959. Based upon the taxes actually paid to country Y and the per-country limitation applicable with respect to country Y, in each of the taxable years, the unused foreign tax deemed paid under section 904(d) for taxable year 1959 is as follows:

	Taxable years		
	1957	1958	1959
Per-country limitation on credit for taxes paid to Y	$300	$200	$250
Taxes actually paid to Y in taxable year	200	300	150
Unused foreign tax to be carried back or over from year of origin		100	
Excess limitation applicable to unused credit			(100)
Unused foreign tax absorbed as taxes deemed paid			100

(ii) Since a taxable year beginning before January 1, 1958, cannot constitute a preceding taxable year in which the unused foreign tax for 1958 may be absorbed as taxes deemed paid, the entire unused foreign tax ($100) is absorbed as taxes deemed paid in 1959.

Example (5). (i) C, a calendar year taxpayer using an accrual method of accounting, accrues foreign taxes for the first time in 1961. C chooses the benefits of section 901 for each of the taxable years set forth below and for 1962 elects the overall limitation provided by section 904(a)(2) which, with the Commissioner's consent, is revoked for 1966. Based upon the taxes actually accrued with respect to foreign countries **X** and **Y** for each of the taxable years, the unused foreign tax deemed accrued under section 904(d) in the appropriate taxable years is as follows:

	Per country	Overall	Overall	Overall	Overall	Per country
Taxable years	1961	1962	1963	1964	1965	1966
Limitation:						
Country X	$175					$290
Country Y	125					95
Overall		$250	$800	$300	$400	
Taxes actually accrued:						
Country X	325					200
Country Y	85					100
Aggregate		350	380	425	450	
Unused foreign tax to be carried back or over from year of origin:						
Country X	150					
Country Y						5

	Per country	Overall	Overall	Overall	Overall	Per country
Aggregate		100		125	50	
Excess limitation:						
Country X						90
Country Y	40					
Overall			420			
Unused foreign tax absorbed as taxes deemed accrued under section 904(d) and carried from—						
1961 (Country X)						(90)
1962 (Overall)			(100)			
1964 (Overall)			(125)			
1965 (Overall)			(50)			

(ii) Since the per-country limitation is applicable for 1961 and 1966 only, any unused foreign tax with respect to such years may not be deemed accrued in 1962, 1963, 1964, or 1965, years for which the overall limitation applies. However, the excess limitation for 1966 with respect to country X ($90) is available to absorb a part of the unused foreign tax for 1961 with respect to country X. The difference with respect to country X between the unused foreign tax for 1961 ($150) and the amount absorbed as taxes deemed accrued ($90) in 1966, or $60, may not be carried beyond 1966 since the unused foreign tax may be carried forward only 5 taxable years. There is no excess limitation with respect to country Y for 1961 in respect of the unused foreign tax of country Y for 1966, since the unused foreign tax may be carried back only 2 taxable years.

(iii) Since the overall limitation is applicable for 1962, 1963, 1964, and 1965, any unused foreign tax with respect to such years may not be absorbed as taxes deemed accrued in 1961 or 1966, years for which the per-country limitation applies. However, the excess limitation for 1963 ($420) computed on the basis of the overall limitation is available to absorb the unused foreign tax for 1962 ($100), the unused foreign tax for 1964 ($125), and the unused foreign tax for 1965 ($50), leaving an excess limitation above such absorption of $145 ($420-$275).

[T.D. 6789, 29 FR 19244, Dec. 31, 1964, as amended by T.D. 7294, 38 FR 33081, Nov. 30, 1973; T.D. 7292, 38 FR 33292, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977]

§ 1.904-3 Carryback and carryover of unused foreign tax by husband and wife.

(a) *In General.* This section provides rules, in addition to those prescribed in § 1.904-2, for the carryback and carryover of the unused foreign tax paid or accrued to a foreign country or possession by a husband and wife making a joint return for one or more of the taxable years involved in the computation of the carryback or carryover.

(b) *Joint unused foreign tax and joint excess limitation.* In the case of a husband and wife the joint unused foreign tax or the joint excess limitation for a taxable year for which a joint return is made shall be computed on the basis of the combined income, deductions, taxes, and credit of both spouses as if the combined income, deductions, taxes, and credit were those of one individual.

(c) *Continuous use of joint return.* If a husband and wife make a joint return for the current taxable year, and also make joint returns for each of the other taxable years involved in the computation of the carryback or carryover of the unused foreign tax to the current taxable year, the joint carryback or the joint carryover to the current taxable year shall be computed on the basis of the joint unused foreign tax and the joint excess limitations.

(d) *From separate to joint return.* If a husband and wife make a joint return for the current taxable year, but make separate returns for all of the other taxable years involved in the computation of the carryback or carryover of the unused foreign tax to the current taxable year, the separate carrybacks or separate carryovers shall be a joint carryback or a joint carryover to the current taxable year. If for such current year the per-country limitation applies, then only the unused foreign tax for a taxable year of a spouse for which the per-country limitation applied to such spouse may constitute a carryover or carryback to the current taxable year. If for such current taxable year the overall limitation applies, then only the unused foreign tax for a taxable year of a spouse for which the overall limitation applied to such spouse may constitute a carryover or carryback to the current taxable year.

(e) *Amounts carried from or through a joint return year to or through a separate return year.* It is necessary to allocate to each spouse his share of an unused foreign tax or excess limitation for any taxable year for which the spouses filed a joint return if—

(1) The husband and wife file separate returns for the current taxable year and an unused foreign tax is carried thereto from a taxable year for which they filed a joint return;

(2) The husband and wife file separate returns for the current taxable year and an unused foreign tax is carried to such taxable year from a year for which they filed separate returns but is first carried through a year for which they filed a joint return; or

(3) The husband and wife file a joint return for the current taxable year and an unused foreign tax is carried from a taxable year for which they filed joint returns but is first carried through a year for which they filed separate returns.

In such cases, the separate carryback or carryover of each spouse to the current taxable year shall be computed in the manner described in § 1.904-2 but with the modifications set forth in paragraph (f) of this section. Where applicable, appropriate adjustments shall be made to take into account the fact that, for any taxable year involved in the computation of the carryback or the carryover, either spouse has interest income described in section 904(f)(2) with respect to which the provisions of section 904(f) and § 1.904-4 apply, or dividends described in section 904(f)(1)(B) with respect to which the provisions of section 904(f) and § 1.904-5 apply.

(f) *Allocation of unused foreign tax and excess limitation*—(1) *Limitation*—(i) *Per-country limitation.* The per-country limitation of a particular spouse with respect to a foreign country or United States possession for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) from sources within such country or possession (but not in excess of the joint taxable income from sources within such country or possession) bears to the joint taxable income from such sources.

(ii) *Overall limitation.* The overall limitation of a particular spouse for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) from sources without the United States (but not in excess of the joint taxable income from such sources) bears to the joint taxable income from such sources.

(2) *Unused foreign tax*—(i) *Per-country limitation.* The unused foreign tax of a particular spouse with respect to a foreign country or United States possession for a taxable year for which a joint return is made shall be the excess of his tax paid or accrued to such country or possession over his limitation determined under subparagraph (1)(i) of this paragraph.

(ii) *Overall limitation.* The unused foreign tax of a particular spouse for a taxable year to which the overall limitation applies and for which a joint return is made shall be the excess of his tax paid or accrued to foreign countries and United States possessions over his limitation determined under subparagraph (1)(ii) of this paragraph.

(3) *Excess limitation*—(i) *Per-country limitation taxpayer.* A spouse's excess limitation with respect to a foreign country or possession for a taxable year for which a joint return is made shall be the excess of his limitation determined under subparagraph (1)(i) of this paragraph over his taxes paid or accrued to such country or possession for such taxable year.

(ii) *Overall limitation.* A spouse's excess limitation for a taxable year to which the overall limitation applies and for which a joint return is made shall be the excess of his limitation determined under subparagraph (1)(ii) of this paragraph over his taxes paid or accrued to foreign countries and United States possessions for such taxable year.

(4) *Excess limitation to be applied.* The excess limitation of the particular spouse for any taxable year which is applied against the unused foreign tax of that spouse for another taxable year in order to determine the amount of the unused foreign tax which shall be carried back or over to a third taxable year shall be, in a case in which the excess limitation is determined on a joint return, the sum of the following amounts:

(i) Such spouse's excess limitation determined under subparagraph (3) of this paragraph reduced as provided in subparagraph (5)(i) of this paragraph, and

(ii) The excess limitation of the other spouse determined under subparagraph (3) of this paragraph for that taxable year reduced as provided in subparagraph (5) (i) and (ii) of this paragraph.

(5) *Reduction of excess limitation.*

(i) The part of the excess limitation which is attributable to each spouse for the taxable year, as determined under subparagraph (3) of this paragraph, shall be reduced by absorbing as taxes deemed paid or accrued under section 904(d) in that year the unabsorbed separate unused foreign tax of such spouse, and the unabsorbed unused foreign tax determined under subparagraph (2) of this paragraph of such spouse, for taxable years which begin before the beginning of the year of origin of the unused foreign tax of the particular spouse against which the excess limitation so determined is being applied.

(ii) In addition, the part of the excess limitation which is attributable to the other spouse for the taxable year, as determined under subparagraph (3) of this paragraph, shall be reduced by absorbing as taxes deemed paid or accrued under section 904(d) in that year the unabsorbed unused foreign tax, if any, of such other spouse for the taxable year which begins on the same date as the beginning of the year of origin of the unused foreign tax of the particular spouse against which the excess limitation so determined is being applied.

(6) *Spouses using different limitations.* If an unused foreign tax is carried through a taxable year for which spouses made a joint return and the credit under section 901 for such taxable year is not claimed, and in the prior taxable year separate returns are made in which the per-country limitation applies to one spouse and the overall limitation applies to the other spouse, the amount treated as absorbed in the taxable year for which a joint return is made—

(i) With respect to the spouse for which the per-country limitation applies shall be determined on the basis of the excess limitation which would be allocated to such spouse under subparagraph (3)(i) of this paragraph had the per-country limitation applied for such year to both spouses;

(ii) With respect to the other spouse for which the overall limitation applies shall be determined on the basis of the excess limitation which would be allocated to such spouse under subparagraph (3)(ii) of this paragraph had the overall limitation applied for such year to both spouses.

This subparagraph shall be applied without regard to subparagraph (4)(ii) of this paragraph.

(g) *Illustrations.* This section may be illustrated by the following examples:

Example (1). (a) H and W, calendar year taxpayers, file joint returns for 1961 and 1963, and separate returns for 1962, 1964, and 1965; and for each of those taxable years they choose to claim a credit under section 901. For the taxable years involved, they had unused foreign tax, excess limitations, and carrybacks and carryovers of unused foreign tax as set forth below. The overall limitation applies to both spouses for all taxable years involved in this example. Neither H nor W had an unused foreign tax or excess limitation for any year before 1961 or after 1965. For purposes of this example, any reference to an excess limitation means such a limitation as determined under paragraph (c)(2)(ii) of § 1.904-2 but without regard to any taxes deemed paid or accrued under section 904(d):

	Taxable year				
	1961	1962	1963	1964	1965
Return	Joint	Separate	joint	Separate	Separate
H's unused foreign tax to be carried over or back, or excess limitation (enclosed in parentheses)	$500	$250	($650)	$400	($500)
W's unused foreign tax to be carried over or back, or excess limitation (enclosed in parentheses)	300	(200)	(300)	150	(100)
Total	800		(950)		
Carryovers absorbed:					
W's, from 1961		[1] 200W	100W		
H's, from 1961			[2] 500H		
H's, from 1962			150H		
			100W		
W's, from 1964					50W
H's, from 1964					400H
Carrybacks absorbed:					
W's, from 1964		0	100W		
H's, from 1964			0		

[1] W—absorbed by W's excess limitation.
[2] H—absorbed by H's excess limitation.

(b) Two hundred dollars of the $300 constituting W's part of the joint unused foreign tax for 1961 is absorbed by her separate excess limitation of $200 for 1962, and the remaining $100 of such part is absorbed by her part ($300) of the joint excess limitation for 1963. The excess limitation of $300 for 1963 is not required first to be reduced by any amount, since neither H nor W has any unused foreign tax for taxable years beginning before 1961.

(c) H's part ($500) of the joint unused foreign tax for 1961 is absorbed by his part ($650) of the joint excess limitation for 1963. The excess limitation of $650 for 1963 is not required first to be reduced by any amount, since neither H nor W has any unused foreign tax for taxable years beginning before 1961.

(d) H's unused foreign tax of $250 for 1962 is first absorbed (to the extent of $150) by H's part of the joint excess limitation for 1963, which must first be reduced from $650 to $150 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961, which is a taxable year beginning before 1962. The remaining part ($100) of H's unused foreign tax for 1962 is then absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $200 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part $100 of W's unused foreign tax for 1961, which is a taxable year beginning before 1962.

(e) W's unused foreign tax of $150 for 1964 is first absorbed (to the extent of $100) by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. No part of W's unused foreign tax for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from $650 to $0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961 and of the unabsorbed part ($150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. The unabsorbed part ($50) of W's unused foreign tax for 1964 is then absorbed by W's excess limitation of $100 for 1965. No part of W's unused foreign tax for 1964 is absorbed by W's excess limitation for 1962, since that excess limitation must first be reduced from $200 to $0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964.

(f) No part of H's unused foreign tax of $400 for 1964 is absorbed by H's part of the joint excess limitation for 1963, since H's part of that excess must first be reduced from $650 to $0 by the absorption as taxes deemed paid or accrued in 1963 of H's unused foreign tax of $500 for 1961 and of a part ($150) of H's unused foreign tax for 1962, which are taxable years beginning before 1964. Moreover, no part of H's unused foreign tax of $400 for 1964 is absorbed by W's part of the joint excess limitation for 1963, since W's part of that excess must first be reduced from $300 to $0 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and of the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of a part ($100) of W's unused foreign tax of

$150 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part ($400) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of $500 for 1965.

Example (2). (a) Assume the same facts as those in example (1) except that for 1964 W's unused foreign tax is $20, instead of $150. The carrybacks and carryovers absorbed are the same as in example (1) except as indicated in paragraphs (b) and (c) of this example.

(b) No part of W's unused foreign tax of $20 for 1964 is absorbed by W's excess limitation for 1962, since that excess must first be reduced from $200 to $0 by W's unused foreign tax for 1961, which is a taxable year beginning before 1964. W's unused foreign tax of $20 for 1964 is absorbed by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $100 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964.

(c) For the reason given in paragraph (f) of example (1), no part of H's unused foreign tax of $400 for 1964 is absorbed by H's part of the joint excess limitation for 1963. H's unused foreign tax of $400 for 1964 is first absorbed (to the extent of $80) by W's part of the joint excess limitation for 1963, which must first be reduced from $300 to $80 by the absorption as taxes deemed paid or accrued in 1963 of the unabsorbed part ($100) of W's unused foreign tax for 1961 and of the unabsorbed part ($100) of H's unused foreign tax for 1962, which are taxable years beginning before 1964, and also by the absorption of W's unused foreign tax of $20 for 1964, which is a taxable year beginning on the same date as the beginning of H's taxable year 1964. The unabsorbed part ($320) of H's unused foreign tax for 1964 is then absorbed by H's excess limitation of $500 for 1965.

Example (3). The facts are the same as in example (1) except that the per-country limitation applies to both spouses for all taxable years involved in the example and that excess limitations and the unused foreign taxes relate to a single foreign country. The carryovers and carrybacks are the same as in example (1).

[T.D. 6789, 29 FR 19246, Dec. 31, 1964, as amended by T.D. 7292, 38 FR 33292, Dec. 3, 1973; T.D. 7490, 42 FR 30497, June 15, 1977]

§ 1.904-4 Separate limitation for section 904(f) interest.

(a) *Separate limitation*—(1) *In general.* (i) For taxable years beginning after October 16, 1962, but only with respect to interest resulting from transactions consummated after April 2, 1962, the provisions of subsections (a), (c), (d), and (e) of section 904 shall be applied separately with respect to the taxpayer's income consisting of—

(*a*) Section 904(f) interest (as defined in paragraph (a)(2) of this section), and

(*b*) Other income (as defined in paragraph (a)(3) of this section).

(ii) The provisions of section 904(f) and this section do not alter the rules provided by section 904(b) and paragraph (d) of § 1.904-1 for the election of the overall limitation upon the amount of the foreign tax credit.

(iii) If the taxpayer has not elected the overall limitation, the per-country limitation prescribed in section 904(a)(1) which is applicable to any foreign country or possession of the United States shall be applied separately with respect to the taxpayer's taxable income from sources within that country or possession which is attributable to the other income and a separate limitation computed in the same manner shall be applied separately with respect to his taxable income from sources within that country or possession which is attributable to the section 904(f) interest.

(iv) If the taxpayer has elected the overall limitation prescribed in section 904(a)(2), such limitation shall be applied with respect to all of the taxpayer's taxable income from sources without the United States which is attributable to the other income and, in addition, a separate limitation computed in the same manner as the per-country limitation prescribed in section 904(a)(1) shall be applied separately with respect to the taxpayer's taxable income from sources within each foreign country or possession of the United States which is attributable to the section 904(f) interest from sources within that country or possession.

(v) For purposes of this subparagraph, the separate limitation with respect to section 904(f) interest from sources within a foreign country or possession of the United States shall be applied only to the taxes paid or accrued to such country or possession with respect to such interest, and the separate limitation with respect to other income whether the per-country or overall limitation, shall be applied only with respect to the foreign income taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d) with respect to the income, other than the section 904(f) interest, which is taken into account for purposes of such separate limitation.

(vi) In no case may the overall limitation prescribed in section 904(a)(2) be applied with respect to section 904(f) interest or with respect to foreign income taxes paid or accrued with respect to such interest.

(vii) For special rules for determining the separate limitation for section 904(f) dividends, which is determined independently of the separate limitation for section 904(f) interest, see § 1.904-5.

(2) *Section 904(f) interest defined.* For purposes of this section, section 904 (f) interest shall be all interest income of the taxpayer for the taxable year other than interest—

(i) Derived from any transaction which, in accordance with paragraph (b) of this section, is directly related to the active conduct by the taxpayer of a trade or business in a foreign country or a possession of the United States,

(ii) Derived in the conduct by the taxpayer of a banking, financing, or similar business within the meaning of paragraph (c) of this section,

(iii) Received, before January 1, 1966, from a corporation, domestic or foreign, in which the taxpayer owns at least 10 percent of the voting stock,

(iv) Received, after December 31, 1965, in taxable years ending after such date, from a corporation, domestic or foreign, in which the taxpayer (or one or more includible corporations in an affiliated group, as defined in section 1504 and the regulations thereunder, of which the taxpayer is a member) owns, directly or indirectly, at least 10 percent of the voting stock, or

(v) Received on obligations acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country or possession of the United States or as a result of the disposition of stock or obligations of a corporation, domestic or foreign, in which the taxpayer owned at least 10 percent of the voting stock.

For purposes of subdivisions (iii) and (iv) of this subparagraph, the 10-percent ownership requirement must be satisfied only at the time the interest is received. For purposes of subdivision (iv) of this subparagraph, stock owned, directly or indirectly, by or for a foreign corporation shall be considered as being proportionately owned by its shareholders. For purposes of subdivision (v) of this subparagraph, an obligation shall include any bond, note, debenture, certificate, or other evidence of indebtedness and the 10-percent ownership requirement must be satisfied only at the time of the disposition of the stock or obligations of the corporation.

(3) *Other income defined.* For purposes of this section, other income is all income of the taxpayer for the taxable year other than section 904(f) interest (as defined in paragraph (a)(2) of this section) and other than section 904(f) dividends (as defined in section 904(f) (1)(B) and § 1.904-5(a)(2)).

(4) *Date transaction is consummated*—(i) *In general.* The determination for purposes of subparagraph (1) of this paragraph of whether a transaction has been consummated after April 2, 1962, shall be made based upon the facts and circumstances in a particular case. A transaction shall be considered consummated on or before April 2, 1962, if it is made pursuant to an agreement all the significant terms of which have been agreed upon on or before that date by all the parties to the agreement. The mere signature after April 2, 1962, by one or more parties to an agreement, all the significant terms of which have been agreed upon on or before that date by all the parties to the agreement, shall not in and of itself prevent such transaction from being considered consummated on or before April 2, 1962. Generally, a transaction which results from an agreement for which the negotiations commenced on or before April 2, 1962, but the significant terms of which were agreed upon after such date,

shall be considered consummated after April 2, 1962.

(ii) *Performance under contract.* Where there is performance on or before April 2, 1962, under any contract, or after that date under a contract all the significant terms of which have been agreed upon on or before that date, the transaction shall be considered consummated on or before April 2, 1962. Thus, for example, domestic corporation M enters into a contract with B, a resident of foreign country Z, on March 1, 1962, to deliver in the United States certain merchandise to B. M is not engaged in trade or business in country Z but agrees to finance the purchase of the merchandise by B. Delivery is made on September 1, 1962, and the final payment is due 18 months after delivery. For purposes of this section, the transaction is consummated before April 2, 1962. In further illustration, if M were to make delivery on March 1, 1962, under terms which are not finally agreed upon until June 1, 1962, the transaction shall be considered consummated before April 2, 1962.

(iii) *Options.* An option shall, for purposes of this section, be considered consummated on the date the option is exercised. Thus, for example, if domestic corporation N purchases on March 21, 1962, a 30-day option to purchase certain securities issued by a resident of foreign country X and then purchases such securities on April 5, 1962, the transaction shall be considered consummated on April 5, 1962.

(5) *Characterization of income as interest*— (i) *In general.* For purposes of section 904(f) and this section, the determination as to whether an item of income is to be treated as an item of interest shall be made based upon the applicable provisions of U.S. law and any administrative or judicial interpretations made under such law. A provision of the laws of a foreign country or possession of the United States regarding the characterization of an item of income as interest and any judicial or administrative interpretations made under such laws shall not be controlling for purposes of this section.

(ii) *Unstated interest.* Any amount which is treated as interest under section 483 and the regulations thereunder shall be considered interest for purposes of this section.

(6) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Domestic corporation M, a calendar year taxpayer to which the per-country limitation applies, has for 1969 $50,000 of taxable income consisting of section 904(f) interest from sources within foreign country X, $100,000 of other taxable income from sources within that country, and $150,000 of taxable income (none of which is interest income) from sources within foreign country Y. M has no other income (or losses) from sources without the United States in 1969 and has total taxable income from all sources (including countries X and Y) of $2 million. M pays income tax for 1969 to country X of $15,000 with respect to section 904 (f) interest and $60,000 with respect to other income; and $75,000 income tax to country Y. M's U.S. tax (before credit) is assumed to be $1 million. M's foreign tax credit limitation under section 904(a)(1) is determined as follows:

Country X:	
Limitation with respect to section 904(f) interest from sources within country X: $1,000,000 × $50,000 ÷ $2,000,000	$25,000
Limitation with respect to other income from sources within country X: $1,000,000 × $100,000 ÷ $2,000,000	50,000
Country Y:	
Limitation with respect to income from sources within country Y: $1,000,000 × $150,000 ÷ $2,000,000	75,000

Example (2). Assume the same facts as in example (1) except that M elects the overall limitation for 1969 and also has for that year $80,000 of taxable income consisting of section 904(f) interest from sources within country Y on which M pays to country Y $12,000 income tax. The limitation under section 904(a)(2) on M's credit for foreign taxes is determined as follows, assuming U.S. tax (before credit) of $1,040,000 and total taxable income of $2,080,000:

Country X: Limitation with respect to section 904(f) interest from sources within country X: $1,040,000 × $50,000 ÷ $2,080,000	$25,000
Country Y: Limitation with respect to section 904(f) interest from sources within country Y: $1,040,000 × $80,000 ÷ $2,080,000	40,000
Overall limitation with respect to other income from countries X and Y: $1,040,000 × $250,000 ÷ $2,080,000	125,000

Example (3). Assume the same facts as in example (2) except that M does not elect the overall limitation and that during 1969 M also received a dividend of $30,000 from its wholly owned subsidiary N, a corporation organized under the laws of country Y which is not a less developed country corporation and which does not meet the tests of section 245. An income tax of $1,500 imposed by country Y is withheld by N from the dividend paid to M; in addition, on receipt of the dividend, M is deemed under section 902(a) (1) to have paid $10,000 foreign income tax to country Y. Assuming a U.S. tax (before credit) of $1,060,000 and total taxable income of $2,120,000, M's total credit for foreign income taxes for 1969 is $163,500, determined as follows:

Country X:		
Taxes paid to country X with respect to section 904(f) interest from sources within country X		$15,000
Limitation with respect to such section 904(f) interest: $1,060,000 × $50,000 ÷ $2,120,000		25,000
Credit allowed under section 901(b)(1) with respect to section 904(f) interest from sources within country X		15,000
Taxes paid to country X with respect to other income from sources within country X		60,000
Limitation with respect to such other income: $1,060,000 × $100,000 ÷ $2,120,000		50,000
Credit allowed under section 901(b)(1) with respect to other income from sources within country X		50,000
Country Y:		
Taxes paid to country Y with respect to section 904(f) interest from sources within country Y		12,000
Limitation with respect to such section 904(f) interest: $1,060,000 × $80,000 ÷ $2,120,000		40,000
Credit allowed under section 901(b)(1) with respect to section 904(f) interest from sources within country Y		12,000
Taxable income (other than section 904(f) interest) from sources within country Y:		
Dividend	$30,000	
Gross-up under section 78	10,000	
Other income	150,000	190,000
Taxes paid (and deemed paid under section 902(a)(1)) with respect to other income from sources within country Y ($75,000 + $1,500 + $10,000)		86,500
Limitation with respect to such other income: $1,060,000 × $190,000 ÷ $2,120,000		95,000
Credit allowed under section 901 with respect to other income from sources within country Y		86,500
Summary of allowable credit:		
Country X tax with respect to:		
Section 904(f) interest	$15,000	
Other income	50,000	
Country Y tax with respect to:		
Section 904(f) interest	12,000	
Other income	86,500	
Total allowable credit		163,500

(b) *Transactions directly related to the active conduct of a trade or business*— (1) *Definition of active conduct of a trade or business.* For purposes of applying section 904(f) and this section, a determination of whether a taxpayer is engaged in the active conduct of a trade or business in a foreign country or possession of the United States shall be made based upon the facts and circumstances in the particular case. However, in no case shall the mere purchasing, holding, or disposing of investment properties, such as stocks or securities, by a taxpayer for his own account be considered, for such purposes, as the active conduct of a trade or business. The fact that a taxpayer is considered or is not considered, for purposes of a section of the Code other than section 904(f), to be engaged in the active conduct of a trade or business in a foreign country or possession of the United States may be taken into account, but shall not necessarily be controlling, for purposes of this subparagraph. Thus, for example, if a corporation is considered, for purposes of section 355 and the regulations thereunder, to be engaged in the active conduct of a trade or business in a foreign country or possession of the United States, this factor may be taken into account for purposes of determining if such corporation is so engaged for purposes of this subparagraph. The period of time for which a taxpayer has conducted a trade or business in a foreign country or possession of the United States may be taken into account in determining whether the conduct of such trade or business is the active conduct of a trade or business for purposes of this subparagraph. The fact that a foreign corporation is treated under section 1504(d) as a domestic corporation will not preclude the interest income of such corporation from qualifying under paragraph (a)(2)(i) of this section.

(2) *Direct relationship of transaction*—(i) *In general.* The transactions which shall be considered directly related to a trade or business which, in accordance with subparagraph (1) of this paragraph, constitutes the active conduct of a trade or business in a foreign country or possession of the United States include, but are not limited to—

(*a*) The sale, exchange, or other disposition of (*1*) property which is purchased, manufactured, produced, constructed, grown, or extracted in the ordinary course of such trade or business or (*2*) an asset which is used in, or held for use in, the conduct of such trade or business,

(*b*) The performance in the ordinary course of such trade or business of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or similar services,

(*c*) The performance of any activity which is an ordinary and necessary incident to the conduct of such trade or business, or

(*d*) The satisfaction of any requirement or condition for carrying on such trade or business.

Thus, for example, if credit is extended or money is advanced by a taxpayer in the ordinary course of his trade or business in order to secure an outlet for goods or services furnished by the taxpayer, then such extension or advance shall, for purposes of this section, be considered a transaction which is directly related to the active conduct of that trade or business. In further illustration, if, pursuant to the laws of a foreign country or possession of the United States or a judicial or administrative interpretation made under such laws, a taxpayer who is engaged in the active conduct of a trade or business in that country or possession is required, as a condition to the conduct of that trade or business, to acquire bonds issued by such country or possession, such acquisition shall, for purposes of this section, be considered a transaction which is directly related to the active conduct of that trade or business. Also, if cash in excess of immediate business requirements is retained as an ordinary and necessary incident to the active conduct of a trade or business in a foreign country or possession of the United States to provide for peak requirements resulting from seasonal fluctuations or similar occurrences, interest from short-term securities in which such cash is invested shall be considered to be derived from a transaction which is directly related to the active conduct of that trade or business. For purposes of this paragraph, a transaction may be directly related to a trade or business which is actively conducted in more than one foreign country or possession of the United States, and any interest derived from that transaction may be excluded under section 904(f)(2)(A) even though it is derived from sources outside such countries or possessions.

(ii) *Assets used in trade or business.* For purposes of subdivision (i)(*a*)(*2*) of this subparagraph an asset shall be treated as used in, or held for use in, the active conduct of a trade or business in a foreign country or possession of the United States if the asset is—

(*a*) Held for the principal purposes of promoting the present conduct of that trade or business,

(*b*) Acquired and held in the ordinary course of that trade or business, as, for example, in the case of an account or note receivable arising from that trade or business, or

(*c*) Otherwise held in a direct relationship to that trade or business, as determined under subdivision (iii) of this subparagraph.

(iii) *Relationship between holding of asset and trade or business.* In determining for purposes of subdivision (ii) (*c*) of this subparagraph whether an asset is held in a direct relationship to a trade or business actively conducted in a foreign country or possession of the United States, principal consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business actively conducted in a foreign country or possession of the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in a foreign country or possession of the United States if, for example, the asset is held for the purpose of providing for (*a*) future diversification into a new trade or business, (*b*) expansion of the taxpayer's trade or business activities conducted outside such country or possession, (*c*) future plant replacement, or (*d*) future business contingencies. Generally, an asset will be treated as held in a direct relationship to the trade or business conducted in a foreign country or possession if the asset was acquired with funds generated by that trade or business, the income from the asset is retained or reinvested in that trade or business, and personnel who are present in a foreign country or possession and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

(c) *Banking, financing, or similar business*—(1) *In General.* A taxpayer will be considered to be engaged in the conduct of a banking, financing, or similar business for purposes of paragraph (a)(2)(ii) of this section if he is engaged in business, whether in the United States or in a foreign country or possession of the United States, and the activities of such business consist of any one or more of the following activities carried on in transactions with persons situated within or without the United States:

(i) Receiving deposits of money from the public,

(ii) Making personal, mortgage, industrial, or other loans to the public,

(iii) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(iv) Issuing letters of credit to the public and negotiating drafts drawn thereunder,

(v) Providing trust services for the public,

(vi) Financing foreign exchange transactions for the public, or

(vii) Carrying on an insurance company business.

Although the fact that the taxpayer is subjected to the banking and credit laws of a foreign country or possession of the United States shall be taken into account in determining whether he is engaged in the conduct of a banking, financing, or similar business in that country or possession, the character of the business actually carried on during the taxable year therein shall determine whether the taxpayer is conducting a banking, financing, or similar business therein. This paragraph shall be applied without reference to paragraph (b) of this section.

(2) *Relation of asset to the business.* If securities are acquired as an ordinary and necessary incident to the conduct of a banking, financing, or similar business, as defined in subparagraph (1) of this paragraph, interest income from such securities shall be considered to be derived in the conduct of a banking, financing, or similar business for purposes of this section but only so long as the retention of such securities remains an ordinary and necessary incident to the conduct of such business. Thus, the acquisition of a security acquired as a result of, or in order to prevent, a loss in a banking, financing, or similar business upon a loan contracted in the ordinary course of such business shall be considered ordinary and necessary to the conduct of such business, but interest on such security shall be considered derived in the conduct of a banking, financing, or similar business only so long as the holding of such security remains an ordinary and necessary incident to the conduct of such business. The term "securities", as used in this subparagraph, means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

(3) *Income from other business activity* If, in addition to conducting a banking, financing, or similar business, a taxpayer carries on other business activities (for example, the business of selling or manufacturing, goods or merchandise, from which it realizes income, gain, or loss) only the interest derived in the conduct of the banking, financing, or similar business shall be excluded under section 904(f)(2)(B) and paragraph (a)(2)(ii) of this section (see, however, paragraph (a)(2)(i) of this section).

(d) *General rules for carryback and carryover of unused foreign tax applicable to section 904(f) interest*—(1) *Modifications in use of § 1.904-2.* For purposes of applying the provisions of § 1.904-2 in conjunction with this section, and except as otherwise provided in paragraph (e) of this section—

(i) *Unused foreign tax.* The term "unused foreign tax", when used with respect to section 904(f) interest for any taxable year, means, with respect to a particular foreign country or possession of the United States, the excess of

(*a*) The income, war profits, and excess profits taxes paid or accrued in such year to such foreign country or possession with respect to such interest, as determined under subparagraph (2) of this paragraph, over

(*b*) The separate limitation for such year with respect to such interest.

Any unused foreign tax for such year with respect to other income shall be determined under § 1.904-2(b)(2) (i) or (ii), whichever applies, without taking into account any amounts used in applying the preceding provisions of this paragraph (d)(1)(i).

(ii) *Tax deemed paid or accrued.* The amount of an unused foreign tax for any taxable year with respect to section 904(f) interest, in the case of a particular foreign country or possession of the United States, which shall be deemed paid or accrued in any other taxable year to which such unused foreign tax may be carried under paragraph (b) of § 1.904-2 shall be equal to the smaller of—

(*a*) The portion of such unused foreign tax which, under paragraph (b) of § 1.904-2, is carried to such other taxable year, or

(*b*) Any excess limitation for such other taxable year with respect to such unused foreign tax. The amount of an unused foreign tax for any taxable year with respect to other income which is deemed paid or accrued in such other taxable year shall be determined under § 1.904-2(c) (1) or (2), whichever applies, without taking into account any amounts used in applying the preceding provisions of this paragraph (d)(1)(ii).

(iii) *Excess limitation.* The excess limitation for any taxable year (hereinafter called the "excess limitation year") applicable to an unused foreign tax with respect to section 904(f) interest, in the case of a particular foreign country or possession of the United States, for another taxable year (hereinafter called the "year of origin") shall be the amount, if any, by which the limitation for the excess limitation year in the case of that foreign country or possession with respect to section 904(f) interest exceeds the sum of—

(*a*) The income, war profits, and excess profits taxes actually paid or accrued to such foreign country or possession in the excess limitation year with respect to section 904(f) interest, and

(*b*) The portion of the unused foreign tax with respect to section 904(f) interest, in the case of such foreign country or possession for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year under paragraph (d)(1)(ii) of this section.

The excess limitation for such excess limitation year with respect to other income shall be determined under § 1.904-2(c)(1) (ii) or (2)(ii), whichever applies, without taking into account any amounts used in applying the preceding provisions of this paragraph (d)(1)(iii).

(iv) *Modification of restrictions on carrybacks and carryovers.* Notwithstanding section 904(e) (2) and subparagraphs (1)(iii) and (2) (iii) of § 1.904-2(c), but subject to the limitations of this section—

(*a*) An unused foreign tax with respect to section 904(f) interest for any taxable year may be deemed paid or accrued in another taxable year for which the overall limitation provided in section 904(a)(2) applies, even though the taxable year from which such tax is carried is a taxable year for which the per-country limitation provided in section 904(a)(1) applies,

(*b*) An unused foreign tax with respect to section 904(f) interest for any taxable year may be deemed paid or accrued in another taxable year for which the per-country limitation provided in section 904(a)(1) applies, even though the taxable year from which such tax is carried is a taxable year for which the overall limitation provided in section 904(a)(2) applies, and

(*c*) An unused foreign tax for any taxable year with respect to other income may be deemed paid or accrued in another taxable year for which the separate limitation with respect to section 904(f) interest applies, if the same limitation applies for both of such taxable years with respect to other income.

(v) *Separation of limitations.* In applying this subparagraph—

(*a*) No portion of an unused foreign tax with respect to section 904(f) interest for any taxable year may reduce the excess limitation for any other taxable year with respect to other income,

(*b*) No portion of an unused foreign tax for any taxable year with respect to other income may reduce the excess limitation for any other taxable year with respect to section 904(f) interest, and

(*c*) If an unused foreign tax with respect to section 904(f) interest for any taxable year is not deemed paid or accrued in another taxable year to which such unused foreign tax may be carried under paragraph (b) of § 1.904-2, such other taxable year is to be counted as one of the years to which such unused foreign tax may be carried.

The application of this subdivision (v) may be illustrated by the following example:

Example. Domestic corporation D, a calendar year taxpayer, does not elect the overall limitation for 1963, 1964, and 1965, in each of which years it chooses the benefits of section 901. For 1965 D has an unused foreign tax of $100 with respect to section 904(f) interest. For 1963 D has an excess limitation of $200, but only with respect to other income. Since the unused foreign tax for 1965 consists only of income taxes imposed on section 904(f) interest and an excess limitation does not exist with respect to such taxes for 1963, the unused foreign tax for 1965 shall not be deemed paid or accrued under section 904(d) in 1963.

(2) *Amount of taxes paid with respect to section 904(f) interest*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, the amount of taxes paid or accrued with respect to section 904(f) interest for purposes of this section shall include only those foreign income taxes which are actually paid or accrued by a taxpayer to a foreign country or possession of the United States with respect to such interest. Thus, for such purposes, the amount of taxes a taxpayer is deemed to have paid for a taxable year under a section of the Code other than section 904(d) shall not be considered taxes paid with respect to section 904(f) interest.

(ii) *Taxes not specifically allocable to included interest.* If a taxpayer has paid or accrued for a taxable year an amount of foreign income taxes with respect to income which consists only in part of section 904(f) interest, but such taxes cannot be specifically allocated to the section 904(f) interest, the amount of such taxes which is to be taken into account for purposes of subdivision (i) of this subparagraph is that amount which bears the same ratio to the total of such foreign income taxes as the net section 904(f) interest bears to the total net amount of such income. For purposes of such apportionment the net section 904 (f) interest and the total net income are to be determined by deducting any credits, expenses, losses, and other deductions which are properly allocable to the gross amount of such income under the law of the foreign country or possession of the United States to which the foreign income taxes have been paid or accrued. If the taxpayer determines that because of the facts and circumstances in a particular case the application of the two proceeding sentences does not result in a proper allocation of the foreign income taxes to the section 904(f) interest, he may make such other reasonable allocation as will, in the opinion of the district director, more clearly reflect the proper allocation of the foreign income taxes to the section 904(f) interest. For purposes of this section, the term "foreign income taxes" means income, war profits, and excess profits taxes, and taxes included in the term "income, war profits, and excess profits taxes" by reason of section 903, imposed by a foreign country or a possession of the United States.

(3) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. N, a calendar year taxpayer using the cash receipts and disbursements method of accounting, pays foreign income taxes for the first time in 1965. For each of the taxable years set forth below N chooses the benefits of section 901 and elects the overall limitation. N has section 904(f) interest only from foreign countries X and Y for the years involved. Based upon the taxes actually paid to foreign countries X and Y for each of the taxable years with respect to section 904(f) interest, and the foreign income taxes paid with respect to the other income from sources without the United States, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years					
	1965	1966	1967	1968	1969	1970
Separate limitation with respect to sec. 904(f) interest:						
Country X	$50	$130	$70	$90	$50	$60
Country Y	240	190	180	120	150	250
Taxes actually paid with respect to sec. 904(f) interest:						
Country X	50	100	70	90	80	40
Country Y	300	190	180	200	110	100
Overall limitation with respect to other income	150	250	200	300	500	400
Taxes actually paid with respect to other income	150	200	600	250	300	400
Unused foreign tax with respect to—						
Sec. 904(f) interest from:						
Country X					30	
Country Y	60			80		
Other income			400			
Excess limitation with respect to—						
Sec. 904(f) interest from:						
Country X		30				20
Country Y					40	150
Other income		50		50	200	
Unused foreign tax absorbed as taxes deemed paid under sec. 904 (d) with respect to—						
Sec. 904(f) interest from:						
Country X						20
Country Y and carried:						
From 1965					40	20
From 1968						80
Other income		50		50	200	

(e) *Transitional rules for carrybacks and carryovers with respect to pre-1962 years*—(1) *Carrybacks to years before Revenue Act of 1962.* (i) Where, under the provisions of section 904(d), taxes paid or accrued to any foreign country or possession of the United States in any taxable year beginning after October 16, 1962, are deemed paid or accrued in one or more taxable years beginning on or before that date, the amount of the taxes so deemed paid or accrued shall be determined without regard to the provisions of section 904(f) and this section.

(ii) To the extent the taxes paid or accrued to a foreign country or possession of the United States in any taxable year beginning after October 16, 1962 (hereinafter referred to as the "year of origin") are not, after applying subdivision (i) of this subparagraph, deemed paid or accrued in any taxable year beginning on or before that date, such taxes shall, for purposes of applying section 904(d) and this section, be deemed paid or accrued in another taxable year beginning after that date—

(*a*) With respect to section 904(f) interest, in the same ratio as the amount of taxes paid or accrued to such country or possession with respect to such interest for the year of origin (to the extent in excess of the applicable limitation for that year) bears to the total amount of taxes paid or accrued to such country or possession for the year of origin (to the extent in excess of the applicable limitation for that year), and

(*b*) With respect to other income, in the same ratio as the amount of taxes paid or accrued to such country or possession with respect to such other income for the year of origin (to the extent in excess of the applicable limitation for that year) bears to the total amount of taxes paid or accrued to such country or possession for the year of origin (to the extent in excess of the applicable limitation for that year).

(iii) The apportionment provided by subdivision (ii) of this subparagraph shall not apply if, after applying section 904 (d) and (e) and paragraph (d) of § 1.904-2 in respect of any unused foreign tax for a taxable year beginning after October 16, 1962, no taxes are in fact deemed paid or accrued in any taxable year beginning on or before that date to which such unused foreign tax may be carried back. Thus, no taxes are deemed paid or accrued in any taxable year beginning on or before October 16, 1962, and the apportionment provided by subdivision (ii) of this subparagraph shall not apply if—

(*a*) There is no excess limitation for any such taxable year beginning on or before that date;

(*b*) The per-country limitation provided by section 904(a)(1) applies to each such year, and the unused foreign tax is carried back from a taxable year beginning after October 16, 1962, for which the overall limitation provided by section 904(a)(2) applies; or

(*c*) The overall limitation provided by section 904(a)(2) applies to each such year, and the unused foreign tax is carried back from a taxable year beginning after October 16, 1962, for which the per-country limitation provided by section 904(a)(1) applies.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). M, a calendar year taxpayer use of the per-country limitation in each of method of accounting, chooses to claim a credit under section 901 for 1962 through 1965, foreign income taxes being paid for the first time in 1962. Based upon the taxes actually paid to foreign country X, and the use of the per-country limitation in each of such years, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years			
	1962	1963	1964	1965
Per-country limitation	$100			
Taxes actually paid to country X	90			
Limitation with respect to—				
Sec. 904(f) interest		$50	$50	$50
Other income		80	50	60
Taxes actually paid to country X with respect to—				
Sec. 904(f) interest		20	20	50
Other income		80	90	10
Unused foreign tax with respect to—				
Sec. 904(f) interest				
Other income			40	
Excess limitation with respect to—				
Sec. 904(f) interest		30	30	
Other income				50
Total income	10			
Unused foreign tax absorbed as taxes deemed paid under sec. 904(d) with respect to—				
Sec. 904(f) interest				
Other income ($30 × $40/$40)				30
Total income	10			

Example (2). The facts are the same as in example (1) except for the changes in the amounts of the limitation and of the taxes actually paid. The unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years			
	1962	1963	1964	1965
Per-country limitation	$100			
Taxes actually paid to country X	90			
Limitation with respect to—				
Sec. 904(f) interest		$50	$50	$60.00
Other income		80	50	50.00
Taxes actually paid to country X with respect to—				
Sec. 904(f) interest		20	60	25.00
Other income		80	90	10.00
Unused foreign tax with respect to—				
Sec. 904(f) interest			10	
Other income			40	
Excess limitation with respect to—				
Sec. 904(f) interest		30		35.00
Other income				40.00
Total income	10			
Unused foreign tax absorbed as taxes deemed paid under sec. 904(d) with respect to—				
Sec. 904(f) interest:				
($40 × $10/$50)		8		
($32 × $10/$50)				6.40
Other income ($32 × $40/$50)				25.60
Total income	10			

Example (*3*). A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, chooses to claim a credit under section 901 for each of the taxable years set forth below, foreign income taxes being paid for the first time in 1962. Based upon the taxes actually paid to foreign country X, and the use of the per-country limitation in each of such years, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years						
	1962	1963	1964	1965	1966	1967	1968
Per-country limitation	$350						
Taxes actually paid to country X	250						
Per-country limitation with respect to—							
Sec. 904(f) interest		$100	$200	$150	$300	$225	$250.00
Other income		200	400	195	400	450	430.00
Taxes actually paid to country X with respect to—							
Sec. 904(f) interest		300	200	100	150	200	200.00
Other income		600	250	275	400	400	300.00
Unused foreign tax with to—							
Sec. 904(f) interest		200					
Other income		400		80			
Excess limitation with respect to—							
Sec. 904(f) interest				50	150	25	50.00
Other income			150			50	130.00
Total income	100						
Unused foreign tax for 1963 absorbed as taxes deemed paid under sec. 904(d) with respect to—							
Sec. 904(f) interest:							
($350 × $200/$600; or limitation, if less)				50			
($300 × $200/$600; or limitation, if less)					100		
($200 × $200/$600; or limitation, if less)						25	
($125 × $200/$600; or limitation, if less)							41.67
Other income:							
($500 × $400/$600; or limitation, if less)			150				
($200 × $400/$600; or limitation, if less)						50	
($125 × $400/$600; or limitation, if less)							83.33
Total income	100						
Unused foreign tax for 1965 absorbed as taxes deemed paid under sec. 904(d) with respect to—							
Sec. 904(f) interest							
Other income ($130 − $83.33)							46.67

Example (*4*). D, a calendar year taxpayer using the cash receipts and disbursements method of accounting, pays foreign income taxes for the first time in 1962. For each of the taxable years set forth below D chooses the benefits of section 901 and elects the overall limitation. D has section 904(f) interest only from foreign country X for the years indicated. Based upon the taxes actually paid to foreign countries X and Y for each of the taxable years with respect to income other than section 904(f) interest, and the taxes paid to country X with respect to section 904(f) interest, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years						
	1962	1963	1964	1965	1966	1967	1968
Separate limitation with respect to sec. 904(f) interest		$100	$200	$150	$300	$233	$250
Taxes actually paid to country X with respect to sec. 904(f) interest		300	200	100	150	200	200
Overall limitation with respect to other income	$350	300	400	195	400	490	430
Taxes actually paid with respect to other income	250	600	250	275	500	400	300
Unused foreign tax with respect to—							
Sec. 904(f) interest		200					
Other income		300		80	100		
Excess limitation with respect to—							
Sec. 904(f) interest				50	150	33	50
Other income			150			90	130
Total income	100						

	Taxable years						
	1962	1963	1964	1965	1966	1967	1968
Unused foreign tax for 1963 absorbed as taxes deemed paid under sec. 904(d) with respect to—							
Sec. 904(f) interest:							
($250 × $200/$500; or limitation, if less)				50			
($200 × $200/$500; or limitation, if less)					80		
($120 × $200/$500; or limitation, if less)						33	
($15 × $200/$500; or limitation, if less)							6
Other income:							
($400 × $300/$500; or limitation, if less)			150				
($120 × $300/$500; or limitation, if less)						72	
($15 × $300/$500; or limitation, if less)							9
Total income	100						
Unused foreign tax with respect to other income absorbed as taxes deemed paid under sec. 904(d) and carried from:							
1965						18	62
1966							59

Example (5). N, a calendar year taxpayer using the cash receipts and disbursements method of accounting, pays foreign income taxes for the first time in 1962. N chooses the benefits of section 901 for each of the taxable years set forth below and for 1962 elects the overall limitation, which, with the Commissioner's consent, is revoked for 1966. N has section 904(f) interest only from foreign country X for the years involved. Based upon the taxes actually paid to foreign countries X and Y for each of the taxable years with respect to other income, and the taxes paid to country X with respect to section 904(f) interest, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years						
	1962	1963	1964	1965	1966	1967	1968
Separate limitation with respect to sec. 904(f) interest		$100	$200	$150	$300	$233	$250.00
Taxes actually paid to country X with respect to sec. 904(f) interest		300	200	100	150	200	200.00
Limitation with respect to other income:							
Country X					100	200	100.00
Country Y					300	290	330.00
Aggregate	$350	300	400	195			
Taxes actually paid with respect to other income to—							
Country X					100	200	100.00
Country Y					400	200	200.00
Aggregate	250	600	250	275			
Unused foreign tax with respect to—							
Sec. 904(f) interest		200					
Other income from:							
Country X							
Country Y					100		
Aggregate		300		80			
Excess limitation with respect to—							
Sec. 904(f) interest				50	150	33	50.00
Other income from:							
Country X							
Country Y						90	130.00
Aggregate	100		150				
Unused foreign tax for 1963 absorbed as taxes deemed paid under sec. 904(d) with respect to—							
Sec. 904 (f) interest:							
($250 × $200/$500; or limitation, if less)				50			
($200 × $200/$500; or limitation, if less)					80		
($120 × $200/$500; or limitation, if less)						33	
($87 × $200/$500; or limitation, if less)							34.80
Other income:							
($400 × $300/$500; or limitation, if less)			150				
Aggregate income	100						

	Taxable years						
	1962	1963	1964	1965	1966	1967	1968
Unused foreign tax with respect to other income absorbed as taxes deemed paid under sec. 904(d) and carried from:							
1965							
1966 (country Y)						90	10.00

Example (6). B, a calendar year taxpayer using the cash receipts and disbursements method of accounting, pays foreign income taxes for the first time in 1962. For each of the taxable years set forth below, B chooses the benefits of section 901 and elects the overall limitation. B has section 904(f) interest only from foreign country X for the years indicated. Based upon the taxes actually paid to foreign countries X and Y for each of the taxable years with respect to other income, and the taxes paid to country X with respect to section 904(f) interest, the unused foreign tax deemed paid under section 904(d) is as follows, after taking into account the prohibition provided in subdivision (iii) of this subparagraph against the apportionment of the unused foreign tax for 1964:

	Taxable years				
	1962	1963	1964	1965	1966
Separate limitation with respect to sec. 904(f) interest		$200	$100	$300	$150
Taxes actually paid to country X with respect to sec. 904(f) interest		175	250	250	50
Overall limitation with respect to—					
Other income		300	150	350	200
Total income	$500				
Taxes actually paid with respect to—					
Other income		270	200	330	160
Total income	500				
Unused foreign tax with respect to—					
Sec. 904(f) interest			150		
Other income			50		
Total income					
Excess limitation with respect to—					
Sec. 904(f) interest		25		50	100
Other income		30		20	40
Total income					

	Taxable years				
	1962	1963	1964	1965	1966
Unused foreign tax for 1964 absorbed as taxes deemed paid under sec. 904(d) with respect to—					
Sec. 904(f) interest		25		50	75
Other income		30		20	0
Total income					

(2) *Carryover to years after Revenue Act of 1962.* (i) Where, under the provisions of section 904(d), taxes paid or accrued to any foreign country or possession of the United States in any taxable year beginning on or before October 16, 1962, are deemed paid or accrued in one or more taxable years beginning after that date, the amount of such taxes which shall be deemed paid or accrued in any taxable year beginning after that date (hereinafter referred to as the "later year") shall be—

(*a*) With respect to section 904(f) interest, an amount which bears the same ratio to the amount of such taxes deemed paid or accrued in the later year as the amount of the foreign income taxes paid or accrued to such country or possession for the later year with respect to section 904(f) interest bears to the total amount of the foreign income taxes paid or accrued to such country or possession for such later year, and

(*b*) With respect to other income, an amount which bears the same ratio to the amount of such taxes deemed paid or accrued in the later year as the amount of the foreign income taxes paid or accrued to such country or possession for the later year with respect to other income bears to the total amount of the foreign income taxes paid or accrued to such country or possession for such later year.

(ii) The apportionment provided by subdivision (i) of this subparagraph shall not apply to any taxable year beginning after October 16, 1962, if, after applying section 904 (d) and (e) and paragraph (d) of § 1.904-2 in respect of any unused foreign tax for a taxable year beginning on or before that date, no taxes are in fact deemed paid in the taxable year beginning after October 16, 1962, even though there may be an excess limitation with respect to section 904(f) interest for that year. Thus, no taxes are deemed paid or accrued in the taxable year beginning after October 16, 1962, and the apportionment provided by subdivision (i) of this subparagraph shall not apply if—

(*a*) There is no excess limitation for the taxable year beginning after October 16, 1962;

(*b*) The per-country limitation provided by section 904(a)(1) applies to such taxable year, and the unused foreign tax is carried over from a taxable year beginning on or before October 16, 1962, for which the overall limitation provided by section 904(a)(2) applies; or

(*c*) The overall limitation provided by section 904(a)(2) applies to such taxable year, and the unused foreign tax is carried over from a taxable year beginning on or before October 16, 1962, for which the per-country limitation provided by section 904(a)(1) applies.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example (*1*). N, a calendar year taxpayer using the cash receipts and disbursements methods of accounting, chooses to claim a credit under section 901 for 1962 through 1965, foreign income taxes being paid for the first time in 1962. Based upon the taxes actually paid to foreign country X, and the use of the per-country limitation in each of such years, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years			
	1962	1963	1964	1965
Per-Country limitation	$100			
Taxes actually paid to country X	350			
Limitation with respect to—				
Sec. 904(f) interest		$140	$40	$100
Other income		30	85	95
Taxes actually paid to country X with respect to—				
Sec. 904(f) interest		20	40	40
Other income		30	20	40
Unused foreign tax with respect to—				
Sec. 904(f) interest				
Other income				
Total income	250			
Excess limitation with respect to—				
Sec. 904(f) interest		120		60
Other income			65	55
Unused foreign tax absorbed as taxes deemed paid under sec. 904(d) with respect to—				
Sec. 904(f) interest:				
($250 × $20/$50)		100		
($100 × $40/$80)				50
Other income:				
($150 × $20/$60)			50	
($100 × $40/$80)				50

Example (*2*). B, a calendar year taxpayer using the cash receipts and disbursements method of accounting, chooses to claim a credit under section 901 for each of the taxable years set forth below, foreign income taxes being paid for the first time in 1961. Based upon the taxes actually paid to foreign country X, and the use of the per-country limitation in each of such years, the unused foreign tax deemed paid under section 904(d) is as follows after taking into account the 5-year limit on the carryover from 1961 and the prohibition provided in subparagraph (1)(iii) of this paragraph against the apportionment of the unused foreign tax for 1963:

	Taxable years							
	1961	1962	1963	1964	1965	1966	1967	1968
Per-country limitation	$200	$350						
Taxes actually paid to country X	900	250						
Limitation with respect to—								
Sec. 904(f) interest			$100	$200	$150	$300.00	$425.00	$25
Other income			200	400	195	400.00	750.00	48

	Taxable years							
	1961	1962	1963	1964	1965	1966	1967	1968
Taxes actually paid to country X with respect to—								
Sec. 904(f) interest			300	200	100	150.00	200.00	200
Other income			600	250	275	500.00	400.00	300
Unused foreign tax with respect to—								
Sec. 904(f) interest			200					
Other income			400		80	100.00		
Total income	700							
Excess limitation with respect to—								
Sec. 904(f) interest					50	150.00	225.00	50
Other income				150			350.00	180
Total income		100						
Unused foreign tax for 1961 absorbed as taxes deemed paid under sec. 904(d) with respect to—								
Sec. 904(f) interest:								
($450 × $100/$375; or limitation, if less)					50			
($400 × $150/$650; or limitation, if less)						92.31		
Other income: ($600 × $250/$450; or limitation, if less)				150				
Total income		100						
Unused foreign tax for 1963 with respect to sec. 904(f) interest absorbed as taxes deemed paid under sec. 904(d)						57.69	142.31	
Unused foreign tax with respect to other income absorbed as taxes deemed paid under sec. 904(d) and carried from:								
1963							350.00	50
1965								80
1966								50

Example (3). C, a calendar year taxpayer using the cash receipts and disbursements method of accounting, pays foreign income taxes for the first time in 1962 and chooses the benefits of section 901 for each of the taxable years set forth below. For 1962, C uses the per-country limitation and in 1963 elects the overall limitation. C's only section 904(f) interest income for the years indicated is from foreign country X. Based upon the taxes actually paid for each of the taxable years with respect to other income, and the taxes paid to country X with respect to the section 904(f) interest, no unused foreign tax is deemed paid under section 904(d), determined as follows:

	Taxable years			
	1962	1963	1964	1965
Separate limitation with respect to sec. 904(f) interest		$100	$300	$150
Taxes actually paid with respect to sec. 904(f) interest		50	200	100
Limitation with respect to other income:				
Per-country limitation	$100			
Overall limitation		250	280	315
Taxes actually paid with respect to other income	160	200	220	280
Unused foreign tax with respect to—				
Sec. 904(f) interest				
Other income	60			
Excess limitation with respect to—				
Sec. 904(f) interest		50	100	50
Other income		50	60	35
Unused foreign tax absorbed as taxes deemed paid under sec. 904(d) with respect to—				
Sec. 904(f) interest				
Other income				

[T.D. 7292, 38 FR 33292, Dec. 3, 1973; 38 FR 34802-03, Dec. 19, 1973; 39 FR 3548, Jan. 28, 1974, as amended by T.D. 7490, 42 FR 30497, June 15, 1977; 42 FR 32536, June 27, 1977]

§ 1.904-5 Separate limitation for section 904(f) dividends.

(a) *Separate limitation*—(1) *In general.* (i) For taxable years ending after December 31, 1971, the provisions of subsections (a), (c), (d), and (e) of section 904 shall be applied separately with respect to the taxpayer's income consisting of—

(A) Section 904(f) dividends (as defined in section 904(f) (1) (B) and paragraph (a) (2) of this section), and

(B) Other income (as defined in paragraph (a) (3) of this section).

(ii) The provisions of section 904(f) and this section do not alter the rules provided by section 904(b) and § 1.904-1(d) for the election of the overall limitation upon the amount of the foreign tax credit.

(iii) If the taxpayer has not elected the overall limitation, the per-country limitation prescribed in section 904(a) (1) which is applicable to any foreign country or possession of the United States shall be applied separately with respect to the taxpayer's taxable income from sources within that country or possession which is attributable to the other income, and a separate limitation computed in the same manner as the overall limitation prescribed in section 904(a) (2) shall be applied separately with respect to the taxpayer's entire taxable income from sources without the United States which is attributable to section 904(f) dividends.

(iv) If the taxpayer has elected the overall limitation prescribed in section 904(a)(2), such limitation shall be applied separately with respect to all of the taxpayer's taxable income from sources without the United States which is atributable to other income, and, in addition, a separate limitation computed in the same manner shall be applied separately with respect to the taxpayer's entire taxable income from sources without the United States which is attributable to section 904(f) dividends.

(v) For purposes of this paragraph, the separate limitation with respect to section 904(f) dividends from sources without the United States shall be applied only with respect to the foreign income taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) with respect to such dividends, and the separate limitation with respect to other income, whether the per-country or overall limitation, shall be applied only with respect to the foreign income taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(d)) with respect to the other income which is taken into account for purposes of such limitation. In the case of a taxpayer who for the taxable year has section 904(f) dividends from more than one corporation, the separate limitation shall be applied with respect to the aggregate of such dividends.

(vi) In no case may the per-country limitation prescribed in section 904(a) (1) be applied with respect to section 904(f) dividends or with respect to foreign income taxes paid, accrued, or deemed to have been paid with respect to such dividends.

(vii) For special rules for determining the separate limitation for section 904 (f) interest, which is determined independently of the separate limitation for section 904(f) dividends, see § 1.904-4.

(2) *Section 904(f) dividends defined.* For purposes of this section, section 904(f) dividends shall be all income of the taxpayer for the taxable year consisting of dividends from a DISC or former DISC (as defined in section 992(a)(1) or (3), as the case may be) to the extent such dividends are treated under sections 861(a)(2) (D) and 862(a)(2), and the regulations thereunder, as income from sources without the United States.

(3) *Other income.* For purposes of this section, other income is all income of the taxpayer for the taxable year other than section 904(f) dividends (as defined in paragraph (a)(2) of this section) and other than section 904(f) interest (as defined in section 904(f)(2) and § 1.904-4(a)(2)).

(b) *General rules for carryback and carryover of unused foreign tax applicable to section 904(f) dividends*—(1) *Modification in use of § 1.904-2.* For purposes of applying the provisions of § 1.904-2 in conjunction with this section, and except as otherwise provided in paragraph (b)(3) of this section—

(i) *Unused foreign tax.* The term "unused foreign tax", when used with respect to section 904(f) dividends for any taxable year, means the excess of—

(A) The income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued other than by reason of section 904(d)), as determined under paragraph (b)(2) of this section, in such year to all foreign countries and possessions of the United States with respect to such dividends, over

(B) The separate limitation for such year with respect to such dividends.

Any unused foreign tax for such year with respect to other income shall be determined under § 1.904-2(b)(2) (i) or (ii), whichever applies, without taking into account any amounts used in applying (A) and (B) of this paragraph (b)(1)(i).

(ii) *Tax deemed paid or accrued.* The amount of an unused foreign tax for any taxable year with respect to section 904(f) dividends which shall be deemed paid or accrued in any other taxable year to which such unused foreign tax may be carried under paragraph (b) of § 1.904-2 shall be equal to the smaller of—

(A) The portion of such unused foreign tax which, under paragraph (b) of § 1.904-2, is carried to such taxable year, or

(B) Any excess limitation for such other taxable year with respect to such unused foreign tax.

The amount of an unused foreign tax for any taxable year with respect to other income which is deemed paid or accrued in such other taxable year shall be determined under § 1.904-2(c) (1) or (2), whichever applies, without taking into account any amounts used in applying (A) and (B) of this paragraph (b)(1)(ii).

(iii) *Excess limitation.* The excess limitation for any taxable year (hereinafter called the "excess limitation year") applicable to an unused foreign tax with respect to section 904(f) dividends for another taxable year (hereinafter called the "year of origin") shall be the amount, if any, by which the limitation for the excess limitation year with respect to section 904(f) dividends exceeds the sum of—

(A) The income, war profits, and excess profits taxes actually paid or accrued to all foreign countries and possessions of the United States in the excess limitation year with respect to section 904(f) dividends,

(B) The income, war profits, and excess profits taxes deemed paid or accrued other than by reason of section 904(d) in such year to all foreign countries and possessions of the United States with respect to section 904(f) dividends, and

(C) The portion of the unused foreign tax with respect to section 904(f) dividends, for any taxable year earlier than the year of origin, which is absorbed as taxes deemed paid or accrued in the excess limitation year.

The excess limitation for such excess limitation year with respect to other income shall be determined under § 1.904-2 (c) (1) (ii) or (2) (ii), whichever applies, without taking into account any amounts used in applying (A), (B), and (C) of this paragraph (b) (1) (iii).

(iv) *Modification of restrictions on carrybacks and carryovers.* Notwithstanding section 904(e) (2) and subparagraphs (1) (iii) and (2) (iii) of § 1.904-2 (c), but subject to the limitations of this subparagraph—

(A) An unused foreign tax with respect to section 904(f) dividends for any taxable year may be deemed paid in another taxable year for which the overall limitation provided in section 904(a)(2) applies, even though the taxable year from which such tax is carried is a taxable year for which the per-country limitation provided in section 904(a) (1) applies.

(B) An unused foreign tax with respect to section 904(f) dividends for any taxable year may be deemed paid or accrued in another taxable year for which the per-country limitation provided in section 904(a) (1) applies, even though the taxable year from which such tax is carried is a taxable year for which the overall limitation provided in section 904(a) (2) applies, and

(C) An unused foreign tax for any taxable year with respect to other income may be deemed paid or accrued in another taxable year for which the separate limitation with respect to section 904(f) dividends applies, if the same limitation applies for both of such taxable years with respect to other income.

(v) *Separation of limitations.* In applying this subparagraph—

(A) No portion of an unused foreign tax with respect to section 904(f) dividends for any taxable year may reduce the excess limitation for another other taxable year with respect to other income.

(B) No portion of an unused foreign tax for any taxable year with respect to other income may reduce the excess limitation for any other taxable year with respect to section 904(f) dividends, and

(C) If an unused foreign tax with respect to section 904(f) dividends for any taxable year is not deemed paid or accrued in another taxable year to which such unused foreign tax may be carried under paragraph (b) of § 1.904-2, such other taxable year is to be counted as one of the years to which such unused foreign tax may be carried.

The application of this subdivision (v) may be illustrated by the following example:

Example. Domestic corporation D, a calendar year taxpayer, does not elect the overall limitation for 1973, 1974, and 1975, in each of which years it chooses the benefits of section 901. For 1975, D has an unused foreign tax of $100 with respect to section 904(f) dividends. For 1973, D has an excess limitation of $200, but only with respect to other income. Since the unused foreign tax for 1975 consists only of income taxes paid, accrued, or deemed paid with respect to section 904(f) dividends and an excess limitation does not exist for 1973 with respect to section 904(f) dividends, the unused foreign tax for 1975 may not be deemed paid or accrued in 1973 under section 904(d).

(2) *Amount of taxes with respect to section 904(f) dividends*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, the amount of taxes paid or accrued with respect to section 904(f) dividends includes primarily the amount of foreign income taxes which a shareholder of a DISC or former DISC is deemed to have paid under section 902(a) on receipt of section 904(f) dividends from the accumulated profits of such corporation. Thus, it includes the portion determined under section 902(a) of the income, war profits, or excess profits taxes paid, or deemed under section 902(b) to be paid, by the DISC or former DISC to any foreign country or possession of the United States on or with respect to the accumulated profits of such corporation from which the section 904(f) dividends are paid, or deemed paid under section 995(b)(1)(D) or (E) or under section 995(c). See § 1.995-1(b) for amounts treated as being received for purposes of this subdivision. However, it also includes foreign income taxes, if any, actually paid or accrued to any foreign country or possession of the United States by the shareholder with respect to section 904(f) dividends from such corporation.

(ii) *Taxes not specifically allocable to dividends.* If a taxpayer has paid or accrued for a taxable year an amount of foreign income taxes with respect to income which consists only in part of section 904(f) dividends, but such taxes cannot be specifically allocated to the section 904(f) dividends, the amount of such taxes which is to be taken into account for purposes of paragraph (b) (2) (i) of this section is that amount which bears the same ratio to the total of such foreign income taxes as the net section 904(f) dividends bear to the total net amount of such income. For purposes of such apportionment the net section 904(f) dividends and the total net income are to be determined by deducting any credits, expenses, losses, and other deductions which are properly allocable to the gross amount of such income under the law of the foreign country or possession of the United States to which the foreign income taxes have been paid or accrued. If the taxpayer determines that because of the facts and circumstances in a particular case the application of the two preceding sentences does not result in a proper allocation of the foreign income taxes to the section 904(f) dividends, he may make such other reasonable allocation as will, in the opinion of the district director, more clearly reflect the proper allocation of the foreign income taxes to the section 904(f) dividends. For purposes of this section, the term "foreign income taxes" means income, war profits, and excess profits taxes and taxes included in the term "income, war profits, and excess profits taxes" by reason of section 903, imposed by a foreign country or a possession of the United States.

(3) *Transitional rules for carrybacks and carryovers with respect to pre-1971 years*—(i) *Carryovers to years ending after December 31, 1971.* Where, under the provisions of section 904(d), taxes paid, accrued, or deemed

to be paid to any foreign country or possession of the United States in any taxable year ending on or before December 31, 1971, are deemed paid or accrued in one or more taxable years ending after December 31, 1971, no amount of such taxes shall be deemed paid or accrued in any such taxable year with respect to section 904(f) dividends.

(ii) *Carrybacks to years ending on or before December 31, 1971.* In applying the provisions of section 904(d) and § 1.904-2(b) to taxes paid, accrued, or deemed to be paid to any foreign country or possession of the United States with respect to section 904(f) dividends in any taxable year ending after December 31, 1971, the terms "second preceding taxable year" and "first preceding taxable year" do not include any taxable year ending on or before December 31, 1971. Thus, no portion of the unused foreign tax with respect to section 904(f) dividends, as determined under paragraph (b) (1) (i) of this section, for any taxable year ending after December 31, 1971, shall be absorbed as taxes deemed paid or accrued in any taxable year ending on or before December 31, 1971.

(c) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Domestic corporation M, a calendar year taxpayer to which the per-country limitation under section 904(a) (1) applies, in 1973 receives a dividend of $50,000 from corporation N, which is a DISC, and a dividend of $150,000 from corporation P, which is a DISC. Under § 1.902-2(a), both N and P are treated as foreign corporations which are not less developed country corporations. Of the dividend from N, $40,000 is a section 904(f) dividend under paragraph (a) (2) of this section; and of the dividend from P, $140,000 is a section 904(f) dividend. In addition, M receives $30,000 of section 904 (f) interest (as defined in § 1.904-4(a) (2)) from sources in foreign country X and $300,000 of other income, consisting of $100,000 from sources in country X and $200,000 from sources in foreign country Y. M has no other income (or loss) from sources without the United States in 1973 and has total taxable income from all sources of $2 million. M pays income taxes for 1973 to country X of $3,000 with respect to section 904(f) interest and $35,000 with respect to other income; and $100,000 income tax to country Y. It is assumed that the foreign income taxes deemed paid by M under section 902(a)(1) with respect to the section 904(f) dividends from N are $10,000 and that the foreign income taxes deemed paid by M under section 902(a)(1) with respect to the section 904(f) dividends from P are $35,000. Thus, the total foreign income taxes paid or deemed to be paid by M for 1973 amount to $183,000. M's U.S. tax (before foreign tax credit) is assumed to be $960,000. Based upon such assumptions, M's foreign tax credit limitation under section 904, and the tax allowable as a credit, are determined as follows for 1973:

(i) Separate limitation with respect to sec. 904(f) dividends:	
Sec. 904(f) dividends from N	$40,000
Gross-up under sec. 78	10,000
Total	50,000
Sec. 904(f) dividends from P	140,000
Gross-up under sec. 78	35,000
Total	175,000
Numerator of limiting fraction	225,000
Limitation ($960,000 × $225,000/$2,000,000)	108,000
(ii) Separate limitation under § 1.904-4 with respect to sec. 904(f) interest from sources in country X: $960,000 × $30,000/$2,000,000	14,400
(iii) Limitation under sec. 904(a)(1) with respect to other income:	
Country X ($960,000 × $100,000/$2,000,000)	48,000
Country Y ($960,000 × $200,000/$2,000,000)	96,000
(iv) Summary of allowable credit:	
Foreign income taxes with respect to sec. 904(f) dividends ($45,000 taxes but not to exceed limitation of $108,000)	45,000
Foreign income tax with respect to sec. 904(f) interest ($3,000 tax but not to exceed limitation of $14,400)	3,000
Country X tax on other income ($35,000 tax but not to exceed limitation of $48,000)	35,000
Country Y tax on other income ($100,000 tax but not to exceed limitation of $96,000)	96,000
Total allowable credit	179,000

Example (2). The facts are the same as in example (1) except that M elects the overall limitation under section 904(a)(2) for 1973. Based upon such assumptions, M's foreign tax credit limitation under section 904, and the tax allowable as a credit, are determined as follows for 1973:

(i) Separate limitation with respect to sec. 904(f) dividends:	
Sec. 904(f) dividends from N	$40,000
Gross-up under sec. 78	10,000
Total	50,000
Sec. 904(f) dividends from P	140,000
Gross-up under sec. 78	35,000
Total	175,000
Numerator of limiting fraction	225,000
Limitation ($960,000 × $225,000/$2,000,000)	108,000

(ii) Separate limitation under § 1.904-4 with respect to sec. 904(f) interest from sources in country X: $960,000 × $30,000/$2,000,000	14,400
(iii) Limitation under sec. 904(a) (2) with regard to other income: ($960,000 × $300,000/$2,000,000)	144,000
(iv) Summary of allowable credit:	
Foreign income taxes with respect to sec. 904(f) dividends ($45,000 taxes but not to exceed limitation of $108,000)	45,000
Foreign income tax with respect to sec. 904(f) interest ($3,000 tax but not to exceed limitation of $14,000)	3,000
Foreign income tax on other income ($135,000 taxes but not to exceed limitation of $144,000)	135,000
Total allowable credit	183,000

Example (*3.*) Domestic corporation M, a calendar year taxpayer using the cash receipts and disbursements method of accounting, pays foreign income taxes for the first time in 1970. For each of the taxable years set forth below M chooses the benefits of section 901 and elects the overall limitation under section 904(a)(2). M has section 904(f) dividends only from DISC corporations N and P for each of the years 1972 to 1975. Based upon the taxes deemed paid under section 902(a) (1) with respeet to section 904(f) dividends for each of the years involved, and the foreign income taxes paid with respect to the other income from sources without the United States, the unused foreign tax deemed paid under section 904(d) is as follows:

	Taxable years					
	1970	1971	1972	1973	1974	1975
Sec. 904(f) dividends from:						
Corporation N			30	100	80	90
Corporation P			40		60	80
Taxes deemed paid under sec. 902(a)(1) with respect to dividends from:						
Corporation N			20	110	90	100
Corporation P			10		10	90
Total sec. 904(f) dividends (including sec. 78 gross-up)			100	210	240	360
Separate limitation with respect to sec. 904(f) dividends			50	105	120	80
Overall limitation with respect to other income	250	350	450	245	630	820
Taxes actually paid with respect to other income	260	310	460	240	650	800
Unused foreign tax with respect to:						
Sec. 904(f) dividends				5		10
Other income	10		10		20	
Excess limitation with respect to:						
Sec. 904(f) dividends			20		20	
Other income		40		5		20
Unused foreign tax absorbed as taxes deemed paid under sec. 904(d) with respect to:						
Sec. 904(f) dividends and carried:						
From 1973			5			
From 1975					10	
Other income and carried:						
From 1970		10				
From 1972		10				
From 1974				5		15

[T.D. 7490, 42 FR 30499, June 15, 1977; 42 FR 32536, June 27, 1977]

§ 1.905-1 When credit for taxes may be taken.

(a) *In general.* The credit for taxes provided in subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed using an accrual method or using the cash receipts and disbursements method. Section 905(a) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under section 905(a) (or under the corresponding provisions of prior internal revenue laws) must be followed in returns for all subsequent year, and no portion of any such taxes accrued in a year in which a credit is claimed will be allowed as a deduction from gross income in any year. See also § 1.905-4.

(b) *Foreign income subject to exchange controls.* If, however, under the provisions of the regulations under section 461, an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income.

§ 1.905-2 Conditions of allowance of credit.

(a) *Forms and information.* (1) Whenever the taxpayer chooses, in accordance with paragraph (d) of § 1.901-1, to claim the benefits of the foreign tax credit, the claim for credit shall be accompanied by Form 1116 in the case of an individual or by Form 1118 in the case of a corporation.

(2) The form must be carefully filled in with all the information called for and with the calculations of credits indicated. Except where it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence, the form must have attached to it (i) the receipt for each such tax payment if credit is sought for taxes already paid, or (ii) the return on which each such accrued tax was based if credit is sought for taxes accrued. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original, or a duly certified or authenticated copy. If the receipt or the return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. Any additional information necessary for the determination under part I (section 861 and following), subchapter N, chapter 1 of the Code, of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the district director, be furnished by the taxpayer. If the taxpayer upon request fails without justification to furnish any such additional information which is significant, including any significant information which he is requested to furnish pursuant to § 1.861-8(f)(5) as proposed in the FEDERAL REGISTER for November 8, 1976, the District Director may disallow the claim of the taxpayer to the benefits of the foreign tax credit.

(b) *Secondary evidence.* Where it has been established to the satisfaction of the district director that it is impossible to furnish a receipt for such foreign tax payment, the foreign tax return, or direct evidence of the amount of tax withheld at the source, the district director, may, in his discretion, accept secondary evidence thereof as follows:

(1) *Receipt for payment.* In the absence of a receipt for payment of foreign taxes there shall be submitted a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income. If credit is claimed on an accrual method, it must be shown that the tax accrued in the taxable year.

(2) *Foreign tax return.* If the foreign tax return is not available, the foreign tax has not been paid, and credit is claimed on an accrual method, there shall be submitted—

(i) A certified statement of the amount shall be submitted—

(ii) Excerpts from the taxpayer's accounts showing amounts of foreign income and tax thereon accrued on its books.

(iii) A computation of the foreign tax based on income from the foreign country carried on the books and at current rates of tax to be established by data such as excerpts from the foreign law, assessment notices, or other documentary evidence thereof.

(iv) A bond, if deemed necessary by the district director, filed in the manner provided in cases where the foreign return is available, and

(v) In case a bond is not required, a specific agreement wherein the taxpayer shall recognize its liability to report the correct amount of tax when ascertained, as required by the provisions of section 905 (c).

If at any time the foreign tax receipts or foreign tax returns become available to the taxpayer, they shall be promptly submitted to the district director.

(3) *Tax withheld at source.* In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, where evidence of withholding and of the amount withheld cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of the tax so withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved.

(c) *Special schedule.* Any taxpayer claiming the benefit of paragraph (a)(2) (iv) or (v) of § 1.904-4 must attach to the Form 1118 required by this section a schedule showing in sufficient detail the manner in which the taxpayer satisfies the requirement of owning, directly or indirectly, 10 percent of the voting stock in each corporation from which such taxpayer receives an interest payment, or in which the taxpayer owned 10 percent of the voting stock, and with respect to which such benefit is claimed.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7292, 38 FR 33300, Dec. 3, 1973; 38 FR 34802, Dec. 19, 1973; T.D. 7456,42 FR 1214, Jan. 6, 1977]

§ 1.905–3 Redetermination of the tax when credit proves incorrect.

(a) *In general.* In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of § 301.6511(d)-3 of this chapter (Regulations on Procedure and Administration).

(b) *Foreign tax imposed on foreign refund.* Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, the amount of the taxes refunded for which credit has been allowed shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund. In such case no credit under section 901, and no deduction under section 164, shall be allowed for any taxable year with respect to such tax imposed on the refund.

(c) *Interest.* Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, no interest shall be assessed or collected on the amount of tax due upon such redetermination resulting from such refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

§ 1.905–4 Credit for taxes accrued but not paid.

In the case of a credit sought for a tax accrued but not paid, the district director may, as a condition precedent to the allowance of a credit, require a bond from the taxpayer, in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual or by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the district director may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. See also 6 U.S.C. 15.

§ 1.905-5 Credit for United Kingdom income taxes paid with respect to royalties.

(a) *General rule.* (1) The taxes deemed to have been paid or accrued under subparagraph (2) of this paragraph by a taxpayer are taxes for which a credit is allowable under section 901.

(2) A taxpayer who has received a royalty (as defined in paragraph (b) of this section) derived from sources within the United Kingdom of Great Britain and Northern Ireland is deemed to have paid or accrued any income, war-profits, or excess-profits taxes paid or accrued to the United Kingdom with respect to such royalty (including the amount by which the payor's United Kingdom tax was increased by inability to deduct such royalty), but only if the taxpayer elects to include in his gross income the amount of such United Kingdom tax. The election provided for in section 905(b) and this subparagraph shall apply only to amounts that are not otherwise includible in gross income under chapter 1.

(3) The credit under this section for taxes deemed paid or accrued with respect to a royalty is allowable in the taxable year in which, under the method of accounting used by the taxpayer, the royalty is includible in his gross income.

(4) No interest shall be allowed or paid on any overpayment resulting from the application of the last sentence of section 905(b) and this section.

(b) *Definition of "royalty".* For purposes of this section, the term "royalty" means a royalty or other amount paid or accrued as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulas, trademarks, and other like property.

(c) *Illustrations.* This section may be illustrated by the following examples:

Example (1). A, a resident of the United Kingdom, has agreed to pay B, a resident of the United States, a royalty of $1,000 per year for the use in the United Kingdom of a patent. At all pertinent times, B is engaged in a trade or business in the United Kingdom through a permanent establishment therein. B computes his taxable income under the cash receipts and disbursements method and files his Federal income tax returns on the calendar year basis. Assume that the United Kingdom standard tax rate is 42.5 percent and assume further that in 1957 A pays the yearly royalty to B and that such royalty is payable wholly out of profits or gains brought into charge to tax within the meaning of the United Kingdom law. Under such circumstances, A is not entitled to a deduction for the royalty in computing his United Kingdom income taxes but may withhold the amount of $425 from the royalty as reimbursement for being denied a deduction. Although B will receive only $575 in 1957, he may include in his gross income for that year the full $1,000 on account of the royalty, instead of just the $575 received and, subject to the limitations contained in section 904, may obtain a credit for the $425 withheld by A. Furthermore, the result would be the same if, under United Kingdom law, the $425 was withheld as tax payable to the United Kingdom by reason that the royalty was not payable out of profits or gains brought into charge to tax.

Example (2). Assume the same facts as stated in example (1), except that the $575 is received by B in 1957 under a "net royalty" agreement. Under such circumstances, B may include in his gross income $1,000 on account of the royalty and, subject to the limitations contained in section 904, may obtain a credit for $425.

§ 1.911-1 Individuals qualifying for the exclusion.

(a) *Scope.* Section 911 provides that a qualifying taxpayer may exclude from gross income qualifying earned income described in § 1.911-2. The amount that may be excluded is subject to the limitation provided in § 1.911-3. Taxpayers may make an election under § 1.911-6(a) not to claim the benefit of section 911.

(b) *Taxpayers qualifying.* A taxpayer qualifies for the exclusion provided by section 911 if the taxpayer resides in a camp located in a hardship area and satisfies either the foreign residence test or the physical presence test of § 1.913-2(a) (1) and (2). A taxpayer is considered to reside in a camp only for portions of the taxable year during which the taxpayer's abode is in a camp. A taxpayer who is away from a camp for short periods of time may still be considered to reside in the camp during those periods of absence. As an illustration, a taxpayer living in a camp who spends weekends or takes periodic vacations of short duration away from the camp may be considered to reside in the camp during those periods of absence. However, a taxpayer who alternates his or her abode between the camp and some other location not in a camp is not considered to reside in the camp while at the other location. As an illustration, a taxpayer who lives and works for 30 days in the camp and then lives and works for 30 days outside a camp will not be considered to reside in the camp during the 30 days while living and working outside a camp. An individual is not considered to reside in a camp located in a hardship area during any period when the area where the camp is located is not designated as a hardship area. (See § 1.913-3(e).)

(c) *Camp*—(1) *In general.* A camp is lodging which is all of the following:

(i) Substandard;

(ii) Provided by or on behalf of the employer for the convenience of the employer because the place where the taxpayer renders services is in a remote area where satisfactory housing is not available to the taxpayer on the open market;

(iii) Located as near as practicable to, and in the vicinity of, the worksite of the taxpayer; and

(iv) Furnished in a common area or enclave which is not available to the general public for lodging or accommodations and which normally accommodates 10 or more persons who are either employees of the taxpayer's employer or other employees performing services at the taxpayer's worksite. For purposes of paragraph (c)(1)(ii) of this section, the term "for the convenience of the employer" has the same meaning which it has for purposes of section 119. For purposes of paragraph (c)(1)(iv) of this section, a cluster of housing units is not a common area or enclave if adjacent to or surrounded by substantially similar housing available to the general public. For purposes of paragraph (c)(1)(iv) of this section, two or more common areas or enclaves which house employees who work on the same project (for example, a highway project) are considered to be one common area or enclave in determining whether they normally accommodate 10 or more employees performing services at the taxpayer's worksite.

(2) *Substandard lodging*—(i) *In general.* Lodging is considered to be substandard if, under all the relevant facts and circumstances, it is appreciably below the standard of housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area of the salary of an employee of the United States who is compensated at an annual rate paid for step 1 of grade GS-14. For purposes of ths section, the salary of an employee is the amount required to be included in the income of the taxpayer as compensation. Relevant facts and circumstances which may indicate that lodging is substandard include (but are not limited to) the following:

(A) Inadequate living space;

(B) Lack of privacy occasioned by communal dining halls or other shared facilities;

(C) Temporary nature of the lodging, such as that inherent in prefabricated housing set in position on cinder blocks or housing consisting of movable units such as mobile homes, trailers, or portable camp facilities;

(D) An immediate environment that exposes the occupants of the housing to unsanitary or unhealthy conditions (for example, open sewers immediately adjacent to the housing) or to unusual risk of personal harm or property loss due to terrorism or civil unrest;

(E) Lack of improvements typically found in residential areas in the

United States, such as paved and lighted streets, recreational areas, sewage facilities, and landscaping; or

(F) The cost per square foot of the lodging if, constructed in the United States would be substantially less than the median cost per square foot to construct housing in the United States.

The general environment in which lodging is located (*e.g.*, the climate, prevalence of insects, etc.) does not of itself make lodging substandard. The general environment is relevant, however, if lodging is inadequate to protect the occupants from environmental conditions. The individual employee's income level is under no circumstances relevant to whether lodging is substandard. Thus, lodging occupied by a particular employee which is substantially inferior to the housing previously occupied by that individual in the United States is not substandard unless it is also substantially inferior to housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of a GS-14, step 1, U.S. Government employee.

(ii) *Presumptions.* Lodging will generally be considered to be substandard if it consists of any of the following:

(A) Portable, temporary, or movable housing occupied by employees who are not accompanied by spouse or dependents, in which the living space intended to be occupied by each employee is less than 250 square feet;

(B) Portable, temporary, or movable housing occupied by employees who are accompanied by spouse or dependents, in which the total interior living space intended to be occupied by a family unit is less than 800 square feet plus 200 square feet for each family member, other than the employee's spouse, who is expected to reside with the employee, and is no more than 1200 square feet;

(C) Housing which lacks adequate and reliable heating or air conditioning if appropriate for the climate, or adequate and reliable utilities such as electricity or sewage facilities; or

(D) Housing which lacks private sleeping quarters for unrelated individuals, private bath or toilet facilities for unrelated individuals, or fresh hot and cold piped water.

Notwithstanding the fact that lodging is described in paragraph (c)(2)(ii)(A), (B), or (C), lodging will not be considered substandard if it is clearly not inferior to housing typically occupied in the United States by individuals whose income equals the lesser of the median salary paid to American employees residing in the common area or the salary of a GS-14, step 1, U.S. Government employee. For purposes of paragraph (c)(2)(ii)(A) and (B), living space does not include shared areas, such as dining halls, lavatories, or storage facilities which are used by unrelated employees. For purposes of paragraph (c)(2)(ii)(A) and (B), housing is not portable, temporary or movable merely because it is prefabricated.

(iii) *Determination of median salary.* In determining the median salary of American employees residing in the common area, any reasonable method may be used. For example, the median salary may be determined by taking the average of the median salaries of American employees at the beginning and end of the calendar year.

(3) *Remote area.* Solely for purposes of section 911, a remote area is a place where satisfactory housing is unavailable to the taxpayer on the open market within a reasonable commuting distance of the place at which the taxpayer renders services.

(i) *Facts and circumstances.* Facts and circumstances to be considered in determining if satisfactory housing is unavailable within a reasonable commuting distance include (but are not limited to):

(A) The inaccessibility to available housing due to geographic factors or the quality of the roads;

(B) The number of housing units available on the open market within a reasonable commuting distance in relation to the number of housing units required for the employer's employees;

(C) The cost of housing available on the open market; or

(D) Terrorism or civil unrest present in the area where housing would be available which would subject U.S.

citizens to unusual risk of personal harm or property loss.

(ii) *Presumptions.* Satisfactory housing will generally be considered to be unavailable to the employee on the open market if any of the following conditions is satisfied:

(A) The foreign government requires the employer to provide housing for its employees other than housing available on the open market;

(B) An unrelated person awarding work to an employer requires that the employer's employees occupy housing specified by such person; or

(C) The place at which the employee renders services is not within a reasonable commuting distance of a community with a population of 50,000 or more individuals.

The conditions of paragraph (c)(3)(ii)(A) and (B) are not fulfilled if the requirement described therein applies primarily to American employers or employers of American employees and there is a significant number of foreign employers or employees other than Americans.

(d) *Hardship area.* A hardship area is defined in § 1913-3(e).

(e) *Section 119 and business premises.* With respect to a taxpayer who excludes income pursuant to section 911, a camp as defined in paragraph (c) of this section is considered to be part of the business premises of the taxpayer's employer for purposes of section 119 for the portion of the taxable year during which the taxpayer satisfies the foreign residence test or the physical presence test of § 1913-2(a)(1) and (2) and resides in a camp located in a hardship area.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76133, Nov. 18, 1980]

§ 1.911-2 Qualifying earned income.

(a) *In general.* Qualifying earned income is earned income (defined in paragraph (b) of this section) which—

(1) Is attributable to services performed in a foreign country (defined in § 1.913-3(d)) during the portions of the taxable year during which the taxpayer resides in a camp located in a hardship area and satisfies the foreign residence test or the physical presence test of § 1.913-2(a) (1) and (2);

(2) Is not paid by the U.S. government or any U.S. government agency or instrumentality;

(3) Is not received as a pension or annuity or included in the taxpayer's gross income by reason of section 402(b) (relating to the taxability of a beneficiary of a nonexempt trust) or section 403(c) (relating to the taxability of a beneficiary under a nonqualified annuity or under annuities purchased by exempt organizations); and

(4) Is not received after the close of the taxable year following the taxable year in which the services giving rise to the income are performed.

For purposes of paragraph (a)(1) of this section, the place of receipt of income is immaterial in determining whether income is derived from services performed in a foreign country.

(b) *Definition of "earned income"*—(1) *In general.* "Earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered. "Earned income" does not include any portion of compensation paid by a corporation which represents a distribution of earnings and profits rather than a reasonable allowance for personal services actually rendered to the corporation.

(2) *Earned income from business in which capital is material.* In the case of a taxpayer engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer shall be considered earned income. In no case, however, may the total amount to be treated as earned income exceed 30 percent of the taxpayer's share of the net profits of the trade or business.

(3) *Earned income and employed assistants.* Earned income includes all fees received by a taxpayer engaged in a professional occupation (such as a doctor or lawyer) in the performance of professional activities. Professional fees constitute earned income even though the taxpayer employs assis-

tants to perform part or all of the services rendered, provided the taxpayer's patients or clients look to the taxpayer as the person responsible for the services rendered.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76134, Nov. 18, 1980]

§ 1.911-3 Determination of the maximum excludable amount of qualifying earned income.

(a) *Application of the limitation*—(1) *In general.* Qualifying earned income described in § 1.911-2 is excludable only to the extent of the limitation specified in paragraph (b) of this section for the taxable year in which the income is earned. Income is considered to be earned in the taxable year in which the services giving rise to the income are performed. Earned income is not to be attributed to any year in which the services performed are insubstantial in nature. The determination of the amount of excluded earned income in this manner does not affect the time for reporting any amounts included in gross income.

(2) *Illustrations.* Paragraph (a)(1) of this section is illustrated by the following examples:

Example (1). B, a U.S citizen and cash-basis taxpayer, is a *bona fide* resident of foreign country X for the entire taxable years 1980 and 1981. During that entire period, B resides in a camp located in a hardship area. In 1981, B receives $40,000 for services performed in country X during 1980 and 1981. Of the total amount received in 1981 ($40,000), $30,000 is attributable to services performed during 1980, and $10,000 is attributable to services performed during 1981. The limitation specified in § 1.911-3(b) is $20,000 for income earned in each of the years 1980 and 1981. Thus, $20,000 of the $30,000 earned in 1980 and the entire $10,000 earned in 1981 are excluded in 1981 (the year of receipt). The nonexcludable $10,000 of the $30,000 earned in 1980 must be included in B's gross income in 1981 (the year of receipt).

Example (2). The facts are the same as in example (1), except that in 1982 B receives an additional $5,000 for services performed in country X in 1981. Since the $10,000 of income earned and received in 1981 is excluded, the remaining limitation for income earned in 1981 which is available for earned income received in 1982 is $10,000. Accordingly, the $5,000 earned in 1981 but received in 1982 is excluded from B's gross income in 1982.

(b) *Limitation*—(1) *In general.* The limitation for each entire taxable year on the exclusion of qualifying earned income described in § 1.911-2 equals $20,000 multiplied by the following fraction:

$$\frac{\text{The number of qualifying days}}{\text{The number of days in the taxable year}}$$

(2) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the taxpayer—

(i) Resides in a camp located in a hardship area within the meaning of § 1.911-1(b); and

(ii) Satisfies the foreign residence test or the physical presence test of § 1.913-2(a) (1) and (2).

(c) *Illustrations.* This section is illustrated by the following examples:

Example (1). B, a U.S. citizen and a calendar year, cash-basis taxpayer, is a *bona fide* resident of foreign country X for the period April 1, 1979, through September 30, 1981. B resides in a camp located in a hardship area during that entire period and returns to the United States during that period only for a 3-week vacation in 1980. B receives $50,000 in each of the years 1979, 1980, and 1981 as current compensation for services performed in country X during the portions of those years during which B is a resident of country X. B receives no other compensation. The amounts of excluded income earned in taxable years 1979 through 1981 are computed as follows: of the income earned in 1979, $15,068 ($20,000 × 275/365); of the income earned in 1980, $20,000 ($20,000 × 366/366); and of the income earned in 1981, $14,959 ($20,000 × 273/365).

Example (2). B, a U.S. resident and a calendar year, cash-basis taxpayer, arrives in foreign country Y from the United States on April 24, 1980. B resides in a camp located in a hardship area during the entire time B is in country Y. B remains in country Y until October 25, 1981, at which time B departs for the United States where B remains for the rest of 1981. B qualifies under the physical presence test of § 1.913-2(a)(2) for the period during which B is in country Y. B receives $50,000 in each of the years 1980 and 1981 as current compensation for services performed in country Y during the portions of those years during which B is in country Y. B receives no other compensation. The amounts of excluded income earned in taxable years 1980 and 1981 are computed as follows: of the income earned in 1980, $13,716 ($20,000 × 251/366); and of the income earned in 1981, $16,274 ($20,000 × 297/365).

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76135, Nov. 18, 1980]

§ 1.911-4 Treatment of community income.

(a) *General rule.* This paragraph applies to married taxpayers with community income other than taxpayers described in paragraph (b) of this section. The amount of excluded earned income is first determined separately for each spouse under the rules of §§ 1.911-1 through 1.911-3 on the basis of the income attributable to that spouse's services. The sum of the amounts of excluded earned income so determined for each spouse is the aggregate amount excluded on a joint return. If the couple files separate returns, one-half of the aggregate amount which would be excluded on a joint return constitutes the exclusion on the separate return of each spouse.

(b) *Special rules applicable to married taxpayers to whom section 879 applies.* The following special rules regarding the treatment of community income apply to any U.S. citizen or resident married to a nonresident alien for whom an election under section 6013 (g) or (h) is not in effect to have the nonresident alien spouse treated as a U.S. resident. Section 879 (applicable to taxable years beginning after December 31, 1976) provides that earned income of such couples which is community income under the applicable community property law is treated as the income of the spouse who rendered the services for which the earned income was paid or accrued. The amount of earned income excluded under section 911 from the gross income of the spouse who is a U.S. citizen or resident is thus computed on the basis of the earned income attributed to that spouse under section 879. Any portion of such earned income that is not excluded is taxable to that spouse. The non-resident alien spouse does not compute an excluded amount with respect to any income attributed to that spouse under section 879 since, among other things, nonresident aliens do not qualify for the section 911 exclusion.

(c) *Illustrations.* This section is illustrated by the following examples:

Example (1). B, a U.S. citizen and a cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year. During 1981, B receives $40,000 compensation for services performed during that year in foreign countrys, C, B's spouse and a U.S. citizen, is a resident of the United States during 1981 and receives no compensation during 1981. B's salary is considered community income under the law of state X, the state of residence of both spouses. If the income were not community income $20,000 of the $40,000 received by B would be excluded from B's gross income. As a result, whether B and C files (delete "s") separate returns or a joint return, the aggregate amount excluded from their combined gross income is $20,000.

Example (2). The facts are the same as in example (1), except that C also qualifies for the section 911 exclusion for the entire 1981 taxable year. In addition, C receives $10,000 during the 1981 taxable year for services performed in country S during that year. If all compensation received during 1981 were not community income, $20,00 of the $40,000 received by B would be excluded from B's gross income and the entire $10,000 received by C would be excluded from C's gross income. As a result, whether B and C files separate returns or a joint return, the aggregate amount excluded from their combined gross income is $30,000.

Example (3). B, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year. During 1981, B receives $40,000 compensation for services performed in foreign country X during that year. C, B's spouse and a citizen of country X, and B are both residents of country X during 1981. C receives $10,000 compensation for services performed during that year in country X. Under the law of country X, one-half of B's earnings (or $20,000) belong to C and one-half of C's earnings (or $5,000) belong to B. An election under section 6013 (g) or (h) is not in effect to have C, a nonresident alien, treated as a resident of the United States. As a result, the $40,000 income received by B is treated as the earned income of B under section 879 and is subject to U.S. tax if not otherwise excluded. The amount of earned income excluded by B from gross income is $20,000. The remaining $20,000 received by B is included in B's gross income for 1981. The $10,000 received by C is treated as the earned income of C and is not subject to tax since it is derived by a nonresident alien from sources outside the United States.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76135, Nov. 18, 1980]

§ 1.911-5 Disallowance of deductions and the foreign tax credit.

(a) *Deductions.* No deduction is allowed for any expenses (other than moving expenses), losses, or other otherwise deductible items definitely related (within the meaning of § 1.861-8 in whole or in part to earned income, to the extent they are properly apportioned (under the rules of § 1.861-8) to excluded earned income.

Thus, if the taxpayer earns $60,000 of qualifying earned income during the taxable year, incurs $3,000 of otherwise deductible business expenses allocable to the entire $60,000, and excludes $20,000 of that income, $1,000 of the business expenses ($3,000×$20,000/$60,000) are not deductible, because they are apportioned to the excluded earned income of $20,000. Deductions which are not definitely related to qualifying earned income are deductible to the extent allowed by chapter 1 of the Code. Examples of deductions that are not definitely related are personal and family medical expenses, real estate taxes and mortgage interest on a personal residence, charitable contributions, and deductions for personal exemptions. In the case of a taxpayer engaged in trade or business in which both personal services and capital are material income-producing factors, the deductions definitely related and properly apportioned to qualifying earned income are determined by multiplying the deductions definitely related and properly apportioned to the profits of such trade or business by a fraction, the numerator of which is qualifying earned income and the denominator of which is the profits of such trade or business.

(b) *Foreign taxes.* No deduction or credit is allowed for foreign income, war profits, or excess profits taxes paid or accrued with respect to excluded earned income. To determine the amount of disallowed taxes, multiply the tax imposed on earned income by a fraction the numerator of which is excluded earned income less deductible expenses definitely related in whole or in part to earned income, to the extent they are properly apportioned to excluded earned income (see § 1.911-5(a)), and the denominator of which is earned income less deductible expenses allocable to earned income. If the tax on earned income is imposed under foreign law on earned income and on some other amount (for example, some other type of income or an amount not subject to tax in the United States), the denominator equals the total of the amounts subject to the tax less deductible expenses allocable to all such amounts. The following examples illustrate the determination of foreign income taxes paid or accrued with respect to excluded earned income.

Example (1). A, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year as a bona fide resident of foreign country X. For 1981, A pays $10,000 in income tax to country X. The 10,000 tax is imposed after reduction for allocable expenses and personal deductions not allocable to any particular items of income, on the following amounts: $40,000 received in 1981 for services performed during that year; and $9,000 of unrealized capital gains with respect to stock and other securities owned by A. Of the $40,000 of earned income, $35,000 is qualifying earned income under § 1.911-2; the remaining $5,000 does not qualify for the section 911 exclusion because it is received for services performed in the United States. A incurred $4,000 of expenses which are deductible and allocable to A's earned income. A excludes $20,000 fo qualifying earned income from gross income for 1981. The $9,000 of unrealized capital gains is not subject to tax in the United States. In addition to the $10,000 tax on the above amounts, A pays a separate tax to country X of $800 on $8,000 of interest received during 1981. The amount of country X tax which is properly apportioned to excluded earned income (and, therefore, not deductible or creditable) equals $4,000, which is determined by multiplying the tax of $10,000 by the following fraction:

$$\frac{\text{\$18,000 (\$20,000 excluded earned income less \$2,000 of deductible expenses allocable to excluded income)}}{\text{\$45,000 (\$40,000 of earned income less \$4,000 of deductible expenses plus \$9,000 unrealized capital gains)}}$$

The separate $800 tax imposed on interest income is not apportioned in part to the excluded earned income, and the interest income is disregarded for purposes of apportioning the $10,000 tax.

Example (2). A, a U.S. citizen and cash-basis taxpayer, qualifies for the section 911 exclusion for the entire 1981 taxable year as bona fide resident of foreign country X. In 1981, A receives $50,000 of qualifying earned income for services performed during that year and excludes $20,000 of that income from gross income. Of the $50,000 received by A, $30,000 is for services performed in country X, and $20,000 is for services performed in country Y. Country Y does not tax A's income. Country X imposes a tax of $3,000 on the $30,000 received for services in country X but does not tax A's income received for services in country Y. The $20,000 exclusion is allocated on a pro rata basis between the portion of qualifying earned income subject to tax in country X and the portion not subject to tax. Thus, $12,000 ($20,000 exclusion X $30,000/$50,000) of the $30,000 subject to tax in country X is considered excluded under section 911. The amount of country X tax which is properly apportioned to excluded earned income equals $1,200, which is determined by multiplying the tax of $3,000 by the following fraction:

$$\frac{\text{\$12,000 (excluded earned income subject to country X tax)}}{\text{\$30,000 (income subject to country X tax)}}$$

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76136, Nov. 18, 1980]

§ 1.911-6 Procedural rules.

(a) *Election not to exclude earned income.* A taxpayer who is entitled to the benefit of section 911 may elect under section 911(d) not to exclude earned income as provided in section 911. This election shall be made on Form 2555, which must be filed either with the income tax return or with an amended return. The election is effective only for the taxable year for which the return is filed. The election may be revoked by filing a new Form 2555 with an amended return. An election not to exclude earned income as provided in section 911 enables a qualifying taxpayer, and in certain cases the taxpayer's spouse, to claim the benefits of section 913 (see § 1.913-2(a)). In addition, taxpayers who elect not to exclude income are not subject to the rules of § 1.911-5 relating to the disallowance of deductions and of the foreign tax credit.

(b) *Returns and extensions*—(1) *In general.* Any return filed before completion of the period necessary to qualify a taxpayer for the exclusion under section 911 or the deduction under section 913 shall be filed without regard to the exclusion or deduction provided in those sections. A claim for a credit or refund of any overpayment of tax may be filed, however, if the taxpayer subsequently qualifies for the exclusion or deduction. See section 6012(c) and § 1.6012-1(a)(3), relating to returns to be filed and information to be furnished by taxpayers who qualify for the exclusion under section 911.

(2) *Extensions.* A taxpayer desiring an extension of time (in addition to the automatic extension of time granted by § 1.6081-2) for filing a return until after the completion of the qualifying period described in § 1.913-2(a)(1) or (2) for claiming either the exclusion under section 911 or the deduction under section 913 may apply for an extension on Form 2350, Application for Extension of Time for Filing United States Income Tax Return. The application must be filed with the Director, Internal Revenue Service Center, Philadelphia, Pennsylvania 19255. The application must set forth the facts relied upon to justify the extension of time requested and must include a statement as to the earliest date the taxpayer expects to be entitled to the exclusion or deduction.

(c) *Declaration of Estimated Tax.* In estimating gross income for the purpose of determining whether a declaration of estimated tax must be made for any taxable year, a taxpayer is not required to take into account income which the taxpayer believes will be excluded from gross income under the provisions of section 911. In computing estimated tax, however, the taxpayer must take into account, among other things, the denial of the foreign tax credit for foreign taxes allocable to the excluded income (see § 1.911-5(b)).

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76136, Nov. 18, 1980]

§ 1.911-7 Effective date of §§ 1.911-1 through 1.911-6.

Sections 1.911-1 through 1.911-6 apply to taxable years beginning after December 31, 1978. Those sections also apply to the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95-615, 92 Stat. 3109) to have prior law apply to that taxable year. Prior law is section 911 as amended by section 1011 (a), (b), and (c) of the Tax Reform Act of 1976 (Pub. L. 94-455, 90 Stat. 1610) and by section 701(u)(10) of the Revenue Act of 1978 (Pub. L. 95-600, 92 Stat. 2917). For the rules applicable to earlier taxable years, see 26 CFR §§ 1.911-1 and 1.911-2 (1978).

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76137, Nov. 18, 1980]

§ 1.913-1 Deduction for certain expenses of living abroad.

(a) *In general.* Section 913 allows to qualifying taxpayers a deduction which consists of the following amounts:

(1) The cost-of-living differential described in § 1.913-5;

(2) Qualified housing expenses described in § 1.913-6;

(3) Qualified school expenses described in § 1.913-7;

(4) Qualified home leave transportation expenses described in § 1.913-8; and

(5) The hardship area amount described in § 1.913-9.

The section 913 deduction is a deduction from gross income and is limited to the amount of the foreign source earned income limitation described in § 1.913-4. In addition, special rules in § 1.913-10 apply to married couples, both spouses of which qualify for the section 913 deduction.

(b) *Relation to the foreign tax credit.* The amount of foreign taxes for which a credit may be claimed, determined prior to the application of the limitation of section 904, is not reduced as a result of claiming the benefits of section 913. The section 913 deduction, however, is allocable to income from sources without the United States for purposes of computing the foreign tax credit limitation under section 904.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76137, Nov. 18, 1980]

§ 1.913-2 Taxpayers qualifying for the deduction.

(a) *In general.* A taxpayer qualifies for the section 913 deduction if the taxpayer either—

(1) Is a citizen of the United States and establishes to the satisfaction of the Commissioner that the taxpayer has been a *bona fide* resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year; or

(2) Is a citizen or resident individual of the United States and has been present in a foreign country or countries for at least 510 full calendar days of any period of 18 consecutive months.

A taxpayer does not qualify for the section 913 deduction during a taxable year, however, if the taxpayer excludes from gross income under section 911 any earned income attributable to services performed during that taxable year. In addition, a taxpayer does not qualify for the section 913 deduction for any period during which the taxpayer's spouse derives earned income which is excluded from gross income under section 911 unless the taxpayer's spouse maintains a separate abode which is not within a reasonable commuting distance of the taxpayer's abode.

(b) *Determination of bona fide residence.* Whether a taxpayer is a *bona fide* resident of a foreign country shall be determined by applying, to the extent possible, the principles of section 871 and the regulations thereunder for determining the residence of aliens. Though the period of *bona fide* residence must be uninterrupted, if *bona fide* residence in a foreign country or countries is established, temporary visits to the United States or elsewhere on vacation or business during the taxpayer's period of residence will not necessarily nullify the taxpayer's status as a *bona fide* resident of a foreign country. A taxpayer with earned income from sources within a foreign country is not a *bona fide* resident of that country if—

(1) The taxpayer makes a statement to the authorities of the foreign country claiming to be a nonresident of that country and

(2) The taxpayer is held not subject as a resident of the foreign country to the income tax imposed by that country on such income.

If a taxpayer has made a statement of nonresidence to the authorities of a foreign country which is pending as of any date a determination of the taxpayer's *bona fide* residence is being made, the taxpayer is not considered a *bona fide* resident of the foreign country as of that date.

(c) *The 510-day/18-month requirement*—(1) *In general.* For purposes of paragraph (a)(2) of this section, the term "18 consecutive months" means any period of 18 months duration. The 18-month period may begin with any day of the calendar month. The period ends with the day before the corresponding calendar day in the 18th succeeding month or, if there is no corresponding calendar day, with the last day of the 18th succeeding month. The 18-month period may commence before or after the taxpayer's arrival in a foreign country and may terminate before or after the taxpayer's departure. The 510 full days need not be consecutive, but may be interrupted by periods during which the taxpayer is not present in a foreign country. A taxpayer who has been present in a foreign country and then travels over areas not within any country for less than 24 hours shall not be deemed outside the foreign country during the period of travel, so long as the individual does not travel within the United States. Time spent in a foreign country in the employment of the U.S. government or an agency or instrumentality of the U.S. government counts toward satisfacation of the 510-day requirement. In addition, time spent in a foreign country prior to January 1, 1978, counts toward satisfaction of the 510-day requirement, even though no deduction is allowed under section 913 for that time.

(2) *Illustrations of the 510-day rule.* The 510-day rule is illustrated by the following examples:

Example (1). B, a U.S. citizen, arrives in Venezuela from New York at 12 noon on April 24, 1980. B remains in Venezuela until 2 p.m. on October 25, 1981, at which time B departs for the United States where B remains for the rest of 1981. B is in a foreign country an aggregate of 510 full days during each of the following two 18-month periods: March 17, 1980, through September 16, 1981; and June 2, 1980, through December 1, 1981.

Example (2). C, a resident alien of the United States, travels extensively from the time C leaves the United States on March 6, 1980, until the time C departs England on January 1, 1982, to return to the United States permanently. The schedule of C's travel and the number of full days at each location are listed below:

Country	Time and date of arrival	Time and date of departure	Full days in foreign country
United States		10 p.m. (by air) Mar. 5, 1980	
England	9 a.m., Mar. 6, 1980	10 p.m. (by ship) June 25, 1980	110
United States	11 a.m., June 30, 1980	1 p.m. (by ship) July 19, 1980	0
France	3 p.m., July 24, 1980	11 a.m. (by air) Aug. 22. 1981	393
United States	4 p.m., Aug 22, 1981	9 p.m. (by air) Sept. 4, 1981	0
England	9 a.m., Sept. 5, 1981	9 a.m. (by air) Jan 1, 1982	117
United States	1 p.m., Jan. 1, 1982		

C is not present in a foreign country or countries an aggregate of 510 full days during the 18-month period beginning March 7, 1980 (C's first full day in a foreign country). However, C is present in a foreign country or countries an aggregate of 510 full days during the following 18-month periods: July 1, 1980, through December 31, 1981; and July 25, 1980, through January 24, 1982. The computation with respect to each period may be illustrated as follows:

	Full days in foreign country
First 18-month period (Mar. 7, 1980, through Sept 6, 1981):	
Mar. 7, 1980, through June 24, 1980	110
June 25, 1980, through July 24, 1980	0
July 25, 1980 through Aug. 21, 1981	393
Aug. 22, 1981, through Sept. 5, 1981	0
Sept. 6, 1981	1
Total full days	504
Second 18-month period (July 1, 1980, through Dec. 31, 1981):	
July 1, 1980, through July 24, 1980	0
July 25, 1980, through Aug. 21, 1981	393
Aug. 22, 1981, through Sept. 5, 1981	0
Sept. 6, 1981, through Dec. 31, 1981	117
Total full days	510
Third 18-month period (July 25, 1980, through Jan. 24, 1982):	
July 25, 1980, through Aug. 21, 1981	393
Aug. 22, 1981, through Sept. 5, 1981	0
Sept. 6, 1981, through Dec 31, 1981	117
Jan. 1, 1982, through Jan 24, 1982	0
Total full days	510

Example (3). The facts are the same as in example (2), except that C arrives in in England on February 25, 1980, instead of March 6, 1980. As a result, C is present in a foreign country or countries an aggregate of 510 full days during the 18-month period February 19, 1980, through August 18, 1981, as well as during the latter two of the three periods listed in example (2). The computation with respect to the period commencing February 19, 1980, is illustrated below:

	Full days in foreign country
Feb. 19, 1980, through Feb. 25, 1980	0
Feb. 26, 1980, through June 24, 1980	120
June 25, 1980, through July 24, 1980	0
July 25, 1980, through Aug 18, 1981	390
Total full days	510

Because the 18-month periods commencing February 19, 1980, and July 25, 1980 (the third 18-month period in example (2)), fully overlap the 18-month period commencing July 1, 1980 (the second 18-month period in example (2)), that latter period need not be considered in determining whether C qualifies under the 510-day rule for the days covered by that period.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76137, Nov. 18, 1980]

§ 1.913-3 General definitions.

(a) *Tax home.* For purposes of section 913 and the regulations thereunder, the term "tax home" has the same meaning which it has for purposes of section 162(a)(2). An exception to the general rule is that a taxpayer shall not be considered to have a tax home in a foreign country for any period for which the taxpayer's abode is in the United States. For example, a taxpayer who lives in Detroit, Michigan, but commutes daily to work in Windsor, Ontario, would ordinarily have his or her tax home in Windsor but nevertheless would be ineligible for the deduction for excess foreign living costs. Temporary presence of the taxpayer in the United States does not necessarily mean that the taxpayer's abode is in the United States during that time.

(b) *Qualified second household*—(1) *In general.* A qualified second household is a separate household maintained by a taxpayer for the taxpayer's spouse or dependents who, if minors, are in the taxpayer's legal custody or the joint custody of the taxpayer and spouse. In order to be a qualified second household, the separate household must be maintained in a foreign country at a place other than the tax home of the taxpayer and must be provided because of adverse living conditions at the taxpayer's tax home. The taxpayer's tax home need not be in a hardship area (defined in paragraph (e) of this section) in order for the separate household to be a qualified second household. In no circumstances is a taxpayer considered to maintain more than one qualified second household at the same time.

(2) *Adverse living conditions.* Adverse living conditions are living conditions which are dangerous, unhealthy, or otherwise adverse. If a taxpayer's tax home is in a hardship area (defined in paragraph (e) of this section), living conditions will be considered to be adverse. Adverse living conditions include a state of warfare or civil insurrection in the general area of the taxpayer's tax home. Adverse living conditions exist if the taxpayer's abode is on the business premises of

the employer for the convenience of the employer and, because of the nature of the business premises (for example, a construction site or drilling rig), it is not feasible to provide family housing. The criteria used by the U.S. Department of State in granting a separate maintenance allowance are relevant but not determinative for purposes of determining whether a separate household is provided because of adverse living conditions.

(c) *United States.* The term "United States" when used in a geographical sense includes the possessions of the United States and the areas set forth in section 638(1). It also includes areas described in section 638(2) to the extent that they relate to U.S. possessions.

(d) *Foreign country.* The term "foreign country" means any territory under the sovereignty of a government other than that of the United States. It includes the air space over any such territory. It does not include a possession or territory of the United States.

(e) *Hardship area.* A hardship area is any place in a foreign country (defined in paragraph (d) of this section) which is designated by the Secretary of State as a place where living conditions are extraordinarily difficult or notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925 of Title 5 of the U.S. Code to any officer or employee of the U.S. Government present at that place. Taxpayers who wish to apply for a hardship area determination must apply to the State Department Allowances Staff, Department of State, Washington, D.C. 20520.

(f) *Reasonable commuting distance.* For purposes of sections 911 and 913, a reasonable commuting distance is a distance which is capable of being traveled safely and regularly by customarily available water transportation, including privately owned vehicles in 1 hour.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76138, Nov. 18, 1980]

§ 1.913-4 Foreign source earned income limitation.

(a) *In general.* The deduction allowed under section 913 may not exceed foreign source earned income reduced by the portion of definitely related deductions (within the meaning of § 1.861-8), other than the deduction allowed by section 913, that is properly apportioned to such income. For purposes of this section deductions that are not definitely related, such as personal and family medical expenses, real estate taxes, mortgage interest on a personal residence, charitable contributions, and deductions for personal exemptions do not reduce foreign source earned income.

(b) *Foreign source earned income.* For purposes of the regulations under section 913, foreign source earned income is the earned income (defined in § 1.911-2(b)) which—

(1) Is derived by the taxpayer and, if the taxpayer's spouse shares the taxpayer's abode, by the taxpayer's spouse;

(2) Is attributable to services performed outside the United States during portions of the taxable year during which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2(a) for the section 913 deduction;

(3) Is not excluded from gross income under section 119; and

(4) Satisfies the requirements of § 1.911-2(a) (2), (3), and (4).

For purposes of paragraph (b)(2) of this section, the place of receipt of income is immaterial in determining whether income is attributable to services performed outside the United States.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76139, Nov. 18, 1980]

§ 1.913-5 Cost-of-living differential.

(a) *In general.* The cost-of-living differential for an entire taxable year is the amount specified in tables issued annually by the Internal Revenue Service for the taxpayer's tax home and family size multiplied by the following fraction:

$$\frac{\text{Number of qualifying days}}{\text{Number of days in the taxable year}}$$

The amount which is the cost-of-living differential must be reduced (but not below zero) by the amount of any military or section 912 allowance excludable from gross income of the taxpayer or the taxpayer's spouse which is intended to compensate such person in whole or in part for the cost-of-living of the taxpayer's household (or in a qualified second household).

(b) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2(a) for the section 913 deduction, excluding days for which both meals and lodging are furnished to the taxpayer and the value of both is excluded from the taxpayer's gross income under section 119.

(c) *Change of foreign tax home*—(1) *In general.* If during the taxable year the taxpayer has more than one foreign tax home, the taxpayer must determine the qualifying days with respect to each foreign tax home and compute a separate cost-of-living amount for each pursuant to the rules of this section. The aggregate of those amounts constitutes the taxpayer's cost-of-living differential for the year.

(2) *Illustration.* If the taxpayer's tax home is West Berlin, West Germany, for 200 qualifying days and Paris, France, for 165 qualifying days during the taxable year, the taxpayer must compute two cost-of-living amounts. The first equals the full year's cost-of-living differential specified in the cost-of-living table for West Berlin multiplied by 200/365. The second equals the full year's cost-of-living differential specified for Paris multiplied by 165/365. The sum of the two amounts so computed constitutes the taxpayer's cost-of-living differential for the taxable year.

(d) *Family size*—(1) *In general.* In determining family size, the family includes only the taxpayer and any spouse and dependents who share the taxpayer's abode. A dependent may be considered to share the taxpayer's abode while boarding at a school only if the expenses of room and board are not deducted as qualified schooling expenses. In addition, no person is considered to share the taxpayer's abode during any days for which both meals and lodging are furnished to that person and the value of both is excluded from gross income under section 119. If family size varies during any period within the taxable year during which the taxpayer has a particular foreign tax home, a separate cost-of-living amount must be computed for each portion of that period during which the family size is different. An exception to this general rule is that a dependent who is born during a taxable year is considered to be a family member for the entire taxable year. Those amounts must then be aggregated to determine the cost-of-living differential for the taxable year.

(2) *Illustration.* If all of the days of a taxable year are qualifying days with respect to one foreign tax home and an unmarried taxpayer's only dependent attends a secondary level boarding school for 274 days of the year and lives with the taxpayer during the remaining 91 days, the taxpayer must compute two cost-of-living amounts. The first equals the full year's cost-of-living differential specified in the cost-of-living table for the taxpayer's tax home for a family size of one multiplied by 274/365. The second equals the full year's cost-of-living differential specified for the taxpayer's tax home for a family of two multiplied by 91/365. The sum of the two amounts so computed constitutes the taxpayer's cost-of-living differential for the taxable year.

(e) *Special rules for qualified second households*—(1) *In general.* The cost-of-living differential for the portion of the taxable year during which the taxpayer maintains a qualified second household (defined in § 1.913-3(b)) is determined on the basis of the amount specified for the location of the taxpayer's qualified second household. No cost-of-living differenial is determined for the taxpayer's tax home for any period during which the taxpayer maintains a qualified second household.

(2) *Qualifying days.* In determing under paragraph (b) of this section the number of qualifying days during which the taxpayer maintains a qualified second household, the number of qualifying days is not reduced by days during which the value of the taxpayer's meals and lodging is excluded from gross income under section 119.

(3) *Family size.* Family size is determined as provided in paragraph (d) of this section, except that the family includes only the spouse and any dependents whose abode is the qualified second household. Regardless of whether the taxpayer is actually present in the qualified second household, the taxpayer is considered a family member except during days for which both meals and lodging are furnished to the taxpayer and the value of both is excluded under section 119.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76139, Nov. 18, 1980]

§ 1.913-6 Qualified housing expenses.

(a) *In general.* The amount of qualified housing expenses equals the reasonable housing expenses incurred by or on behalf of the taxpayer and any spouse and dependents who share the taxpayer's abode less the taxpayer's base amount. The amount of qualified housing expenses must be reduced, however, by the amount of any military or section 912 allowance excludable from gross income which is intended to compensate in whole or in part for the expenses of housing located within a reasonable commuting distance of the taxpayer's tax home. Any amount required to be included in income of the taxpayer as compensation attributable to housing provided to the taxpayer shall be considered incurred on behalf of the taxpayer for housing in a foreign country.

(b) *Housing expenses*—(1) *In general.* Housing expenses include rent, utilities (other than long distance telephone charges), real and personal property insurance, occupancy taxes not described in paragraph (b)(1)(v) of this section, nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, residential parking, and repairs. Housing expenses do not include—

(i) The cost of house purchase, improvements and other costs which are capital expenditures;

(ii) The cost of purchased furniture or accessories or domestic labor (maids, gardeners, etc.);

(iii) Amortized payments of principal with respect to an evidence of indebtedness secured by a mortgage on the taxpayer's housing;

(iv) Depreciation of housing owned by the taxpayer, or amortization or depreciation of capital improvements made to housing leased by the taxpayer; or

(v) Interest and taxes deductible under section 163 or 164 or other amounts deductible under section 216 (a).

(2) *Limitation.* Housing expenses are taken into account for purposes of this section only to the extent that they are attributable to housing for portions of the taxable year during which—

(i) The taxpayer's tax home is in a foreign country;

(ii) The value of the taxpayer's housing is not excluded under section 119; and

(iii) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction.

In addition, except as provided in paragraph (d)(1) of this section relating to qualified second households, if the taxpayer maintains more than one foreign abode at the same time, housing expenses are to be taken into account only to the extent that they are incurred with respect to the abode which bears the closest relationship (not necessarily geographic) to the taxpayer's tax home.

(3) *Reasonableness.* An amount paid for housing is reasonable for purposes of paragraph (a) of this section only to the extent that it does not exceed an amount which would be paid for housing which is not lavish or extravagant under the circumstances.

(c) *Base housing amount*—(1) *In general.* The base housing amount equals 20 percent of the excess of the taxpayer's worldwide earned income over the sum of the following amounts—

(i) The portion of definitely related deductions (within the meaning of § 1.861-8), other than the deduction allowed under section 913, which is allocable to worldwide earned income;

(ii) The cost-of-living differential (determined under § 1.913-5);

(iii) The qualified school expenses (determined under § 1.913-7);

(iv) The qualified home leave transportation expenses (determined under § 1.913-8);

(v) The hardship area amount (determined under § 1.913-9); and

(vi) Housing expenses (defined in paragraphs (a) and (b) of this section).

(2) *Worldwide earned income.* Worldwide earned income is earned income (defined in § 1.911-2(b)), whether or not from sources outside the United States, which—

(i) Is derived by the taxpayer and, if the taxpayer's spouse shares the taxpayer's abode, by the taxpayer's spouse;

(ii) Satisfies the requirements of § 1.911-2(a)(2), (3), and (4); and

(iii) Is attributable to services performed during portions of the taxable year during which—

(A) The taxpayer's tax home is in a foreign country;

(B) The value of the taxpayer's housing is not excluded under section 119; and

(C) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction.

(d) *Special rules for qualified second households*—(1) *In general.* Qualified housing expenses may be claimed for housing expenses relating to the taxpayer's tax home and for housing expenses relating to a qualified second household. Qualified housing expenses are computed separately with respect to each.

(2) *Qualified housing expenses for the tax home.* In the case of a taxpayer who maintains a qualified second household, the qualified housing expenses for housing at the taxpayer's tax home are determined as provided in paragraphs (a), (b), and (c) of this section, except that, if the taxpayer's tax home is in a hardship area (defined in § 1.913-3 (e)), the base housing amount with respect to the tax home equals zero rather than the amount determined as provided in paragraph (c) of this section. In determining under paragraph (c) of this section the base housing amount of a taxpayer whose tax home is not in a hardship area, housing expenses in paragraph (c)(1)(vi) of this section do not include the housing expenses incurred with respect to the qualified second household.

(3) *Qualified housing expenses for the qualified second household*—(i) *Expenses.* In determining under paragraph (b) of this section the housing expenses relating to the qualified second household, the limitation of paragraph (b)(2)(ii) of this section does not apply, so that housing expenses may include those incurred for housing during portions of the taxable year during which the value of the taxpayer's housing at the taxpayer's tax home is excluded under section 119. In addition, the words "qualified second household" are substituted for "taxpayer's tax home" in paragraph (a) of this section. Thus, the amount of qualified housing expenses need not be reduced by the amount of any allowance excludable under section 912 for the expenses of housing located at the taxpayer's tax home, but must be reduced by the amount of any military or section 912 allowance excludable from gross income which compensates the taxpayer or the taxpayer's spouse in whole or in part for the expenses of housing at the location of the qualified second household.

(ii) *Base housing amount.* In determining under paragraph (c) of this section the base housing amount relating to the qualified second household—

(A) Housing expenses in paragraph (c)(1)(vi) of this section include those relating both to the qualified second household and to housing at the taxpayer's tax home;

(B) Paragraph (c)(2)(iii)(B) of this section does not apply, so that, subject to the other criteria of paragraph (c)(2) of this section, earned income used in computing the base housing amount includes income attributable to services performed during periods during which the value of the taxpayer's housing is excluded under section 119; and

(C) Worldwide earned income as defined in paragraph (c)(2) of this section does not include income attributable to services performed during any period during which the taxpayer does not maintain a qualified second household.

(e) *Illustrations.* This section is illustrated by the following examples:

Example (1) All of the following facts relate to the entire 1980 taxable year. B qualifies for the section 913 deduction under § 1.913-2(a). B's tax home is in town X, located in foreign country F. Town X is not located in a hardship area. B's spouse and their 1-year old child live in a qualified second household in city Y in foreign country Z. B receives a $40,000 salary from B's corporate employer for services performed in country F and incurs no business expenses. B's employer also pays B a cost-of-living allowance of $4,000 and provides housing owned by the employer with a local fair market rental value of $10,000, fcr which the employer charges B $6,000. The value of the housing furnished by B's employer is not excluded from gross income under section 119. B's total earned income is, therefore, $48,000. B's spouse has no earned income. The cost-of-living differential specified in the 1980 cost-of-living table for country Z, the location of the qualified second household, is $3,000. B pays $15,000 for housing for B's spouse and child. Neither B nor B's spouse incurs any qualified school or home leave transportation expenses.

(a) The qualified housing expenses relating to the housing at B's tax home are computed by subtracting from $10,000 (the full value of B's housing) the base housing amount for the housing at B's tax home. The base housing amount for the housing at B's tax home is $7,000—20 percent of $35,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential and the $10,000 of housing expenses). Thus, the amount of qualified housing expenses relating to the housing at B's tax home equals $3,000.

(b) The qualified housing expenses relating to the qualified second household are computed by substracting from $15,000 (the housing expenses relating to the qualified second household) the base housing amount for the qualified second household. The base housing amount for the qualified second household is $4,000—20 percent of $20,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential, the $10,000 of housing expenses relating to the housing at B's tax home, and the $15,000 of housing expenses incurred with respect to the qualified second household). Thus, the amount of qualified housing expenses relating to the qualified second household equals $11,000.

(c) B's qualified housing expenses equal $14,000, which is the sum of the $3,000 qualified housing expenses relating to the housing at B's tax home and the $11,000 of qualified housing expenses relating to the qualified second household.

Example (2). The facts are the same as in example (1), except that town X is located in a hardship area. The qualified housing expenses relating to the housing at B's tax home equal $10,000, which is the full value of B's housing. The amount of qualified housing expenses relating to the qualified second household equals $11,000 and is computed in the same manner as in paragraph (b) of example (1). Thus, B's qualified housing expenses equal $21,000.

Example (3). The facts are the same as in example (1), except that there is no qualified second household, the cost-of-living differential specified in the 1980 cost-of-living table for country F (the location of B's tax home) is $3,000, and town X is located in a hardship area. The base housing amount for housing at B's tax home equals $6,000—20 percent of $30,000 ($48,000 worldwide earned income less the $3,000 cost-of-living differential, the $10,000 living expenses and the $5,000 hardship area differential). Thus, the amount of B's qualified housing expenses equals $4,000. Although B's tax home is located in a hardship area, B cannot claim as qualified housing expenses the full value of the housing provided at B's tax home, since B does not maintain a qualified second household.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76140, Nov. 18, 1980]

§ 1.913-7 Qualified school expenses.

(a) *Qualified school expenses.* Qualified school expenses are reasonable school expenses incurred by or on behalf of the taxpayer for the education of a dependent of the taxpayer at levels equivalent to grades kindergarten through 12.

(b) *School expenses*—(1) *In general.* School expenses include tuition, fees, the cost of books, other amounts required by the school such as uniforms, and the cost of local transportation. Optional expenses, such as the cost of optional field trips or extracurricular activities, are not school expenses. If an adequate U.S.-type school is not available within a reasonable commuting distance (defined in § 1.913-3(f) of the taxpayer's tax home, the expenses of room and board for the dependent and the cost of transportation between the school and the taxpayer's tax home at the beginning and the end of the school year and during vacation periods are also school expenses. The cost of transportation includes transfer costs to and from the airport, airport taxes, exit fees or nonrefundable deposits made in order to leave the country, meals in route, and costs of involuntary stopovers in route. The cost of transportation does not include the costs of voluntary stopovers in route.

(2) *Limitation.* School expenses are qualified school expenses only to the extent that—

(i) They are not expenses for which a credit is claimed pursuant to section 44A (relating to child care) or for which a deduction is claimed pursuant to section 213 (relating to medical expenses);

(ii) They are not expenses for which the taxpayer or the taxpayer's spouse is compensated by an allowance such as the "school away from post" education allowance which is excluded from gross income under section 912;

(iii) They are attributable to education during a period in which the taxpayer's tax home is in a foreign country and the taxpayer qualifies under § 1.913-2(a) for the section 913 deduction; and

(iv) They are attributable to education during a period in which the dependent resides with the taxpayer at the taxpayer's tax home or in a qualified second household.

(c) *Reasonable expenses.* If an adequate U.S.-type school is available within a reasonable commuting distance (as defined in § 1.913-3(f) of the taxpayer's tax home, the taxpayer's dependents may attend school elsewhere, but tuition is considered reasonable only to the extent that it does not exceed the amount which would be incurred with respect to the school which is within commuting distance. If two or more adequate U.S.-type schools are available within a reasonable commuting distance of the taxpayer's tax home, tuition is considered reasonable only to the extent that it does not exceed the amount which would be incurred with respect to the least expensive of those schools. Round-trip transportation expenses are reasonable only to the extent that they do not exceed the lowest reserved coach or economy rate which is offered without advance booking on the day and at the time of day that the dependent travels. First class fares are considered reasonable only if no coach or economy accommodations are provided to any passengers on the particular flight or if the dependent is required to use first class accommodations because of physical impairment. In addition, the cost of transportation by modes other than air (including ship, rail, and automobile) is not considered reasonable to the extent that the cost of transportation by such other modes exceeds the cost of transportation by air.

(d) *Availability and adequacy.* A school is not considered available under paragraphs (b) and (c) of this section if the school will not accept the taxpayer's dependents for enrollment. A school is not adequate if, because of physical impairment or learning disabilities, the dependent is in need of special educational facilities or training which the school does not provide. A school is not adequate if the dependent desires a college preparatory curriculum and the school does not offer such a curriculum. In addition, a school is not adequate if it is under religious auspices which require religious training or infuse religious training in secular courses and the taxpayer does not send the dependent to another school under the same religious auspices. A school will be considered adequate even though it does not offer enrichment programs, if such programs would not ordinarily be offered in public elementary or secondary schools in the United States. Examples of such enrichment programs are a swimming team or orchestral training.

(e) *U.S.-type school.* A U.S.-type school is any school which offers a curriculum which—

(1) Is taught in English;

(2) Is comparable to that offered by accredited schools in the United States; and

(3) Would qualify the student for graduation if the student were to transfer to a U.S. school.

(f) *Special rules for qualified second households.* If the taxpayer maintains a qualified second household (defined in § 1.913-3(b)), the location of the taxpayer's qualified second household rather than the taxpayer's tax home is to be used to determine what constitutes school expenses under paragraph (b)(1) of this section and whether school expenses are reasonable under paragraph (c) of this section.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76141, Nov. 18, 1980]

§ 1.913-8 Qualified home leave transportation expenses.

(a) *In general.* Qualified home leave transportation expenses are the resonable expenses incurred by or on behalf of the taxpayer for the transportation during the taxable year of the taxpayer or of the taxpayer's spouse or dependents. The expenses must be incurred for round-trip transportation from the location of the taxpayer's tax home (or, with respect to the spouse and dependents, from a qualified second household) to the taxpayer's present or most recent principal residence (whether owned or rented) in the United States or to the port of entry in the continental United States (excluding Alaska) which is nearest to the taxpayer's tax home (or qualified second household). Qualified transportation expenses include transfer costs to and from the airport, airport taxes, exit fees or nonrefundable deposits made in order to leave the country, meals in route, and the costs of involuntary stopovers in route. The cost of transportation does not include the costs of voluntary stopovers in route.

(b) *Limitations*—(1) *One trip for each 12-month period abroad.* Qualified transportation expenses include the cost of no more than one round trip per person for each period of 12 consecutive months (which do not overlap) during which—

(i) The taxpayer's tax home is in a foreign country; and

(ii) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction.

The trip can occur before completion of a 12-month period.

(2) *Spouse and dependents.* Home leave transportation expenses may be claimed for the transportation of a spouse or dependent only if, at the time of the transportation, the spouse or dependent resides with the taxpayer at the taxpayer's tax home or in a qualified second household.

(3) *Double benefits denied.* Qualified transportation expense for each period of 12 consecutive months must be reduced by the amount of any allowance which is granted to the taxpayer or the taxpayer's spouse for purposes of home leave transportation at any time during that period of 12 consecutive months and which is excluded from gross income under section 912.

(c) *Reasonableness.* In determining whether transportation expenses are reasonable, the rules of § 1.913-7(c) (qualified school expenses) as they relate to transportation apply.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76142, Nov. 18, 1980]

§ 1.913-9 Hardship area amount.

(a) *Hardship area amount.* The hardship area amount for an entire taxable year equals $5,000 multiplied by the following fraction:

$$\frac{\text{The number of qualifying days.}}{\text{The total number of days in the taxable year.}}$$

(b) *Qualifying days.* The number of qualifying days is the total number of calendar days in the taxable year during which the following requirements are satisfied:

(1) The taxpayer's tax home is located in a hardship area (defined in § 1.913-3(e)); and

(2) The taxpayer qualifies under § 1.913-2(a) for the section 913 deduction.

A taxpayer's tax home is not considered to be located in a hardship area during any day for which the area where the taxpayer's tax home is located is not designated as a hardship area. To determine the number of days during which the taxpayer's tax home is located in an area designated as a hardship area, see the hardship area list. (The hardship area list is contained in the instructions to Form 2555 or may be obtained from the Director of International Operations, CP:OIO:8, Internal Revenue Service, Washington, D.C. 20225. Taxpayers who wish to apply for a hardship area determination must apply to the State Department Allowances Staff, Department of State, Washington, D.C. 20520.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76142, Nov. 18, 1980]

§ 1.913-10 Married couples with two qualifying spouses.

(a) *In general.* Subject to the rules of this section, in the case of a married couple both spouses of which qualify for the deduction provided in section 913, both spouses may claim the benefit of the deduction. If both spouses claim the benefit of section 913 directly as qualifying taxpayers, however, neither may claim any benefits of section 913 relating to a qualified second household maintained for the other spouse. If one spouse foregoes the benefits which that spouse, as a qualifying taxpayer, could claim under section 913, the other spouse may claim the benefits of section 913 relating to a qualified second household maintained for the first spouse. In such case, the earned income of both spouses is considered in computing the foreign earned income limitation under § 1.913-4 and base housing amount under § 1.913-6(c) of the spouse who claims the benefits of section 913. The rules in paragraphs (b) through (g) of this section apply only to married couples both spouses of which qualify for the deduction provided in section 913 and neither spouse of which claims any benefits relating to a qualified second household maintained for the other spouse.

(b) *Foreign source earned income limitation.* If separate returns are filed and both spouses claim the section 913 deduction, the foreign source earned income limitation for purposes of the separate return of each spouse is computed as provided in § 1.913-4, except that it is to be computed solely on the basis of the earned income derived by that spouse (without regard to community income laws). Otherwise, the limitation is computed as provided in § 1.913-4—that is, on the basis of the combined earned income of both spouses unless they maintain separate abodes.

(c) *Cost-of-living differential.* Except as provided in paragraph (g) of this section, only one cost-of-living differential is permitted for the couple. If separate returns are filed, each spouse's cost-of-living differential equals one-half of the differential computed for the couple.

(d) *Qualified housing expenses*—(1) *Expenses.* Except as provided in paragraph (g) of this section, a married couple may claim qualified housing expenses with respect to only one abode.

(2) *Base housing amount.* If separate returns are filed and both spouses claim the section 913 deduction, the base housing amount for purposes of the separate return of each spouse is computed as provided in § 1.913-6(c), except that it is to be computed solely on the basis of the earned income derived by that spouse (without regard to community income laws). The aggregate of the qualified housing expenses which may be claimed on separate returns may not exceed, however, the amount which would be computed for the couple if a joint return were filed. If separate returns are not filed or if both spouses do not claim the section 913 deduction, the base housing amount is computed as provided in § 1.913-6(c)—that is, on the basis of the combined earned income of both spouses unless they maintain separate abodes.

(e) *Qualified home leave transportation expenses.* Pursuant to § 1.913-8(b)(3), a married couple may not include as qualified home leave transportation expenses the cost of more than one round trip for each spouse or dependent for each period of 12 consecutive months during which the couple's tax home is in a foreign country, even though both spouses independently qualify under § 1.913-2(a) for the section 913 deduction.

(f) *Hardship area amount and joint returns.* Subject to the rules of § 1.913-9, each spouse may claim a hardship area amount. If joint returns are filed, however, the hardship area amount determined for each spouse may not exceed the foreign earned income limitation computed as provided in § 1.913-4, except that it is to be computed solely on the basis of the earned income derived by that spouse (without regard to community income laws).

(g) *Separate tax homes*—(1) *In general.* A married couple that maintains separate abodes may claim a cost-of-living differential and qualified housing expenses with respect to each abode if—

(i) The abodes are not within a reasonable commuting distance of each other; and

(ii) The spouses have different tax homes which are not within a reasonable commuting distance of each other.

(2) *Joint returns.* If under paragraph (g)(1) a cost-of-living differential or qualified housing expenses are claimed with respect to the separate abode of each spouse and a joint return is filed, the aggregate of the following amounts may not exceed the foreign earned income limitation computed as provided in § 1.913-4 solely on the basis of the earned income derived by each spouse (without regard to community income laws):

(i) The cost-of-living differential determined as provided in § 1.913-5 with respect to that spouse's tax home;

(ii) The qualified housing expenses incurred with respect to that spouse's abode determined by using a base housing amount computed as provided in § 1.913-6(c) solely on the basis of the earned income derived by that spouse (without regard to community income laws); and

(iii) The hardship area amount for that spouse.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76142, Nov. 18, 1980]

§ 1.913-11 Married couples with community income.

(a) *Joint return.* Married couples with community earned income who file a joint return must compute their section 913 deduction under the rules of §§ 1.913-1 through 1.913-10. Where relevant, those rules instruct taxpayers with community income to disregard community income laws and treat the income earned by each spouse solely as that spouse's income.

(b) *Separate returns.* Married couples with community earned income (other than taxpayers to whom section 879 applies) who file separate returns must first compute the section 913 deduction as if they filed a joint return. One-half of that amount is the section 913 deduction to be claimed by each spouse on a separate return.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§ 1.913-12 Returns and extensions.

See § 1.911-6(b) relating to returns and extensions for taxpayers qualifying for the section 913 deduction.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§ 1.913-13 Effective date.

Sections 1.913-1 through 1.913-12 apply to taxable years beginning after December 31, 1978. Those sections also apply to the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95-615, 92 Stat. 3109) to have section 911 under prior law apply to that taxable year.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7736, 45 FR 76143, Nov. 18, 1980]

EARNED INCOME OF CITIZENS OF UNITED STATES

§ 1.912-1 Exclusion of certain cost-of-living allowances.

(a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living allowances in accordance with regulations approved by the President are, by the provisions of section 912(1), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 912(1) notwithstanding any combination thereof with any other allowance. For example, the cost-of-living portion of a "living and quarters allowance" would be excluded from gross income whether or not any other portion of such allowance is excluded from gross income.

(b) For purposes of section 912(1), the term "continental United States" includes only the 48 States existing on February 25, 1944 (the date of the enactment of the Revenue Act of 1943 (58 Stat. 21)) and the District of Columbia.

§ 1.912-2 Exclusion of certain allowances of Foreign Service personnel.

Amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131-1158) are, by the provisions of section 912 (2), excluded from gross income.

WESTERN HEMISPHERE TRADE CORPORATIONS

§ 1.921-1 Definition of Western Hemisphere trade corporation.

(a) *In general.* The term "Western Hemisphere trade corporation", for purposes of subtitle A of the Code, means a domestic corporation which meets all of the following tests:

(1) Its entire business for the taxable year is carried on within the Western Hemisphere. In determining whether this test is met, incidental purchases outside the Western Hemisphere will not disqualify the corporation. The term "incidental purchases" as used in section 921 and this section does not have the same meaning as the phrase "purchases incident to the conduct of the business". The term "incidental purchases" means only purchases (of any kind and for any purpose) which are (i) minor in relation to the entire business or (ii) nonrecurring or unusual in character. Whether purchases made outside the Western Hemisphere are incidental purchases for purposes of section 921 and this section shall be determined on the basis of all the facts of each particular case, except that in any case in which the aggregate of the purchases (of any kind and for any purpose) made outside the Western Hemisphere for the taxable year does not exceed an amount equal to 5 percent of the corporation's gross receipts from all sources for such taxable year, such purchases shall be deemed to be incidental purchases. Merely incidental economic contact with countries outside the Western Hemisphere will not disqualify a corporation as a Western Hemisphere trade corporation. For purposes of this section, the term "Western Hemisphere" means the countries in North, Central, and South America, and in the West Indies;

(2) Ninety-five percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) is derived from sources without the United States; and

(3) Ninety percent or more of its gross income for such period or such part thereof is derived from the active conduct of a trade or business. Dividends received by a corporation do not represent income derived from the active conduct of a trade or business.

(b) *Illustrations.* The application of the principles of paragraph (a) of this section may be illustrated by the following examples:

Example (1). X, a domestic corporation, operates a mine in South America and ships its products to England. The fact that X retains title to such goods until acceptance of the bill of lading and draft, solely in order to insure collection, will not cause X to be considered as carrying on business outside the Western Hemisphere, since such passing of title is merely an incidental economic contact outside the Western Hemisphere.

Example (2). Y, a domestic corporation, is engaged in Argentina in the business of manufacturing and selling construction equipment. During 1956, Y purchased in Germany certain motor parts required as an integral part of the equipment which it makes. The amount of such purchases equalled 4 percent of Y's gross receipts for 1956. Such purchases are incidental purchases and do not disqualify Y as a Western Hemisphere trade corporation.

Example (3). Z, a domestic corporation, operates a mine in South America. During 1956, Z, in accordance with its usual practices, purchased in France machinery and equipment necessary in the conduct of its business. The amount of such purchases was not minor in relation to Z's entire business. Such purchases disqualify Z as a Western Hemisphere trade corporation.

(c) *Statement required.* A corporation which claims to qualify as a Western Hemisphere trade corporation shall attach to its income tax return a statement showing: (1) That its entire business is done within the Western Hemisphere and, if any purchases are made outside the Western Hemisphere, the amount of such purchases, the amount of its gross receipts from all sources, and any other pertinent information, and (2) for the 3-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence), (i) its total gross income from all sources, (ii) the amount thereof derived from the active conduct of a trade or business, (iii) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (iv) the amount of its gross income, if any, from sources within the United States. The gross income from sources within the United States and without the United States shall be determined as provided in Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

§ 1.922-1 Special deduction of Western Hemisphere trade corporation.

(a) A special deduction in computing taxable income in the case of a Western Hemisphere trade corporation (as defined in section 921) is allowed in section 922. The fraction specified in section 922 (2) is the same whether the amount of the corporation's taxable income is sufficient to subject it to the combined normal tax and surtax, or only to the normal tax. For the rules applicable in determining the special deduction where the alternative tax under section 1201 is imposed, see the regulations under section 1201.

(b) *Examples.* The computation of the special deduction may be illustrated by the following examples:

Example (1). A corporation which qualifies as a Western Hemisphere trade corporation realized gross income of $100,000 for the calendar year 1954 and had allowable deductions (other than the special deduction allowed by section 922) for that year in the amount of $40,000. The corporation normal tax rate and the surtax rate for the calendar year 1954 are 30 percent and 22 percent, respectively. The corporation's special deduction under section 922 is $16,153.84, computed as follows:

(i) Compute the taxable income by subtracting allowable deductions of $40,000 from gross income of $100,000, with a result of $60,000.

(ii) The sum of the corporation normal tax rate and surtax rate for the calendar year 1954 is 52 percent (30 percent plus 22 percent). The fraction specified in section 922 (2), accordingly, is 14/52.

(iii) The amount of taxable income (subdivision (i)), $60,000, multiplied by the fraction determined under subdivision (ii), 14/52, is $16,153.84 (14/52 times $60,000).

Example (2). Assume that the facts are the same as in example (1) except that the allowable deductions (other than the special deductions allowed by section 922) are $80,000. The corporation's special deduction under section 922 is $5,384.61, computed as follows:

(i) Compute the taxable income by subtracting allowable deductions of $80,000 from gross income of $100,000, with a result of $20,000.

(ii) The sum of the corporation normal tax rate and surtax rate for the calendar year 1954 is 52 percent (30 percent plus 22 percent). The fraction specified in section 922 (2), accordingly, is 14/52, regardless of the fact that the taxable income of the corporation in the amount of $20,000 makes it subject only to the corporation normal tax.

(iii) The amount of taxable income (subdivision (i)), $20,000, multiplied by the fraction determined under subdivision (ii), 14/52, is $5,384.61 (14/52 times $20,000).

(c) *Denial of deduction for a DISC or shareholder thereof.* The special deduction provided by section 922 is not allowed to a corporation for a taxable year (1) for which it qualifies (or is treated) as a DISC or (2) during which it owns directly or indirectly at any time stock in a corporation which, at such time, is (or is treated as) a DISC or former DISC. (See section 992(a)(1) and (3), respectively, for the definitions of the terms "DISC" and "former DISC".) For example, assume X corporation and Y corporation have the same taxable years. On the first day of its taxable year X owns and sells all of the stock in Y. Y on such day owns and sells all of the stock in Z corporation and Z qualifies as a DISC as of such day. Neither X nor Y will be eligible for the special deduction provided by section 922 for their taxable years. Z will likewise not be eligible for the special deduction for the taxable year for which it qualifies as a DISC.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7283, 38 FR 20824, Aug. 3, 1973; 38 FR 22549, Aug. 22, 1973]

POSSESSIONS OF THE UNITED STATES

§ 1.931-1 Citizens of the United States and domestic corporations deriving income from sources within a certain possession of the United States.

(a) *Definitions.* (1) As used in section 931 and this section, the term "possession of the United States" includes American Samoa, Guam, Johnston Island, Midway Islands, the Panama Canal Zone, Puerto Rico, and Wake Island. However, the term does not include (i) the Virgin Islands and (ii), when used with respect to citizens of the United States, the term does not include Puerto Rico or, in the case of taxable years beginning after December 31, 1972, Guam.

(2) As used in section 931 and this section, the term "United States" includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(b) *General rule*—(1) *Qualifications.* In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States—

(i) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(ii) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. The salary or other compensation paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall, for the purposes of section 931 and this section, be deemed to be derived from sources within the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, does not represent income derived from the active conduct of a trade or business within the possession of the United States even though such citizen was actively engaged in the management of such corporation. For a determination of income from sources within the United States, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and section 931(i), and the regulations thereunder.

(2) *Relationship of sections 931 and 911.* A citizen of the United States who cannot meet the 80-percent and the 50-percent requirements of section 931 but who receives earned income from sources within a possession of the United States, is not deprived of the benefits of the provisions of section 911 (relating to the exemption of

earned income from sources outside the United States), provided he meets the requirements thereof. In such a case none of the provisions of section 931 is applicable in determining the citizen's tax liability. For what constitutes earned income, see section 911(b).

(3) *Meaning of "gross income" on joint return.* In the case of a husband and wife making a joint return, the term "gross income," as used in this section, means the combined gross income of the spouses.

(4) *Returns.* A citizen entitled to the benefits of section 931 is required to file with his individual return Form 1040 the schedule on Form 1040E. If a citizen entitled to the benefits of section 931 has no income from sources within the United States and does not receive within the United States any income derived from sources without the United States he is not required to file a return or the schedule on Form 1040E.

(5) *Illustration of the operation of section 931.* This section may be illustrated by the following example:

Example. On July 1, 1954, A, who is a citizen of the United States, went to a possession of the United States and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1954 of some real estate located in such possession and not connected with his trade or business. In the first six months of 1954 he also derived $8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1954. On these facts, A may exclude the $32,000 derived from sources within the possession of the United States, since he qualified under section 931 with respect to that amount. The period of July 1, 1954, through December 31, 1954, constitutes the applicable part of the 3-year period immediately preceding the close of the taxable year (the calendar year 1954), and for that period, 80 percent of A's gross income was derived from sources within a possession of the United States ($32,000, or 80 percent of $40,000) and 50 percent or more of A's gross income was derived from the active conduct of a trade or business within a possession of the United States ($20,000, or 50 percent of $40,000). A is required to report on his return for 1954 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States).

(c) *Amounts received in the United States.* Notwithstanding the provisions of section 931(a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated thereto. For instance, if in the example set forth in paragraph (b)(5) of this section, the taxpayer during the latter part of 1954 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the real estate located in the possession, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 931 with respect to other items of gross income excluded by that section.

(d) *Deductions*—(1) *Individuals.* In the case of a citizen entitled to the benefits of section 931, the deductions allowed in computing taxable income, except the standard deduction and a deduction for one personal exemption (see sections 142(b)(2) and 931(e), respectively), are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of section 873 and the regulations thereunder, relating to the allowance to nonresident alien individuals, who at any time within the taxable year were engaged in trade or business within the United States, of the deductions provided in section 165(c) (2) and (3) for losses not connected with the trade or business, are applicable in the case of citizens entitled to the benefits of section 931. The provisions of section 873 (c) and the regulations thereunder pertaining to the allowance to such nonresident alien individuals of deductions for contributions provided in section 170 are also applied in the case of such citizens.

(2) *Corporations.* Corporations entitled to the benefits of section 931 are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction provided by section 170 to corporations is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(e) *Deduction for personal exemption.* A citizen of the United States entitled to the benefits of section 931 is allowed a deduction for only one exemption under section 151.

(f) *Allowance of deductions and credits.* Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 931 shall file or cause to be filed with the district director a true and accurate return of total income from all sources within the United States, in the manner prescribed in subtitle F of the Code, the tax shall be collected on the basis of the gross income (not the taxable income) from sources within the United States. If such citizen or corporation fails to file a necessary income tax return, the Commissioner will cause a return to be made, including therein all income from sources within the United States and allowing no deductions or credits (except credit for tax withheld at source).

(g) *Foreign tax credit.* Persons entitled to the benefits of section 931 are not allowed the credits provided for in section 901 (relating to credits for taxes of foreign countries and possessions).

(h) *Internees.* If a citizen of the United States—

(1) Was interned by the enemy while serving as an employee within a possession of the United States; and

(2) Was confined in any place not within a possession of the United States, then

(i) Such place of confinement shall be considered as within a possession of the United States for the purposes of section 931; and

(ii) Section 931 (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) *Employees of the United States.* For the purposes of section 931, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

(j) *Nonapplication to a DISC or shareholder thereof.* Section 931 does not apply to a corporation for a taxable year (1) for which it qualifies (or is treated) as a DISC or (2) during which it owns directly or indirectly at any time stock in a corporation which, at such time, is (or is treated as) a DISC or former DISC. (See section 992(a) (1) and (3), respectively, for the definitions of the terms "DISC" and "former DISC".) For example, assume X Corporation and Y Corporation have the same taxable years. On the first day of its taxable year, X owns and sells all of the stock in Y, Y on such day owns and sells all of the stock in Z Corporation, and Z qualifies as a DISC as of such day. Section 931 will not apply to X and Y for their taxable years. Section 931 will likewise not apply to Z for the taxable year for which it qualifies as a DISC.

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (c)) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7283, 38 FR 20825, Aug. 3, 1973; T.D. 7385, 40 FR 50260, Oct. 29, 1975]

§ 1.932-1 Status of citizens of U.S. possessions.

(a) *General rule*—(1) *Definition and treatment.* A citizen of a possession of the United States (except Puerto Rico and, for taxable years beginning after December 31, 1972, Guam), who is not otherwise a citizen or resident of the United States, including only the States and the District of Columbia, is treated for the purpose of the taxes imposed by subtitle A of the Code (relating to income taxes) as if he were a nonresident alien individual. However, for purposes of the tax imposed on self-employment income by chapter 2 of the Code, the term "possession of the United States" as used in section 932 and the preceding sentence does not include American Samoa, Guam, or the Virgin Islands. See section 1402(a)(9). See subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder, for rules relating to imposition of tax on nonresident alien individuals. For Federal income tax purposes, a citizen of a possession of the United States who is not otherwise a citizen of the United States is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization in a State, Territory, or the District of Columbia. The fixed or determinable annual or periodical income from sources within the United States of a citizen of a possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. See section 1441.

(2) *Classification of citizens of United States possessions.* For the purpose of this section citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (i) Citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States, and (ii) citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States. The provisions of subpart A (section 871 and following) and the regulations thereunder, applicable to nonresident alien individuals not engaged in trade or business within the United States are applicable to the citizens of possessions falling within the first class, while the provisions of such sections applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States are applicable to citizens of possessions falling within the second class.

(b) *Nonapplication to citizen of Puerto Rico or Guam.* The provisions of section 932(a) and paragraph (a) of this section do not apply in the case of a citizen of Puerto Rico or, for taxable years beginning after December 31, 1972, a citizen of Guam. Thus, for example, any such citizen who is not a resident of the United States will not be treated by the United States as a nonresident alien individual for purposes of section 2 (b)(3)(A) or (d), relating to definitions and special rules; section 4(d)(1), relating to taxpayers not eligible to use the optional tax tables; section 37(h), relating to denial of retirement income credit; section 116(d), relating to taxpayers ineligible for dividend exclusion; section 142(b)(1), relating to taxpayers ineligible for standard deduction; section 152(b)(3), relating to definition of "dependent"; section 402(a)(4), relating to distributions by the United States to nonresident aliens; section 545(d), relating to certain foreign corporations; section 565(e), relating to certain consent dividends; section 861(a)(1), relating to interest from sources within the United States; sections 871 to 877, relating to nonresident alien individuals; section 1303(b), relating to individuals not eligible for income averaging; section 1371(a)(3), relating to definition of small business corporation; section 1402(b), relating to definition of "self-employment income"; section 1441, relating to withholding of tax on nonresident aliens; section 3401(a), relating to definition of wages; section 6013(a)(1), relating to inability to make a joint return; section 6015 (b) and (i), relating to declaration of estimated income tax by nonresident alien individuals; section 6017, relating to self-employment tax returns; section 6042(b)(2), relating to returns regarding payments of dividends; section 6049(b)(2), relating to returns regarding payments of interest; section 6072 (c), relating to time for filing returns of nonresident alien individuals; section 6091(b), relating to place for filing returns of nonresident aliens; and section 6096(a), relating to designation of tax payments to Presidential Election

Campaign Fund. For other rules applicable to citizens of Puerto Rico, see §§ 1.1-1(b) and 1.933-1. For other rules applicable to citizens of Guam, see §§ 1.1-1(b) and 1.935-1 of this chapter (Income Tax Regulations) and § 301.7654-1 of this chapter (Regulations on Procedure and Administration).

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (e)) of the Internal Revenue Code of 1954)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7385, 40 FR 50260, Oct. 29, 1975]

§ 1.933-1 Exclusion of certain income from sources within Puerto Rico.

(a) *General rule.* An individual (whether a United States citizen or an alien), who is a bona fide resident of Puerto Rico during the entire taxable year, shall exclude from his gross income the income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof. Whether the individual is a bona fide resident of Puerto Rico shall be determined in general by applying to the facts and circumstances in each case the principles of §§ 1.871-2, 1.871-3, 1.871-4, and 1.871-5, relating to what constitutes residence or nonresidence, as the case may be in the United States in the case of an alien individual. Once bona fide residence in Puerto Rico has been established, temporary absence therefrom in the United States or elsewhere on vacation or business trips will not necessarily deprive an individual of his status as a bona fide resident of Puerto Rico. An individual taking up residence in Puerto Rico during the course of the taxable year is not entitled for such year to the exclusion provided in section 933.

(b) *Taxable year of change of residence from Puerto Rico.* A citizen of the United States who changes his residence from Puerto Rico after having been a bona fide resident thereof for a period of at least two years immediately preceding the date of such change in residence shall exclude from his gross income the income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which preceded the date of such change in residence, except amounts received for services performed as an employee of the United States or any agency thereof.

(c) *Deductions.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 933, there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions) properly allocable to, or chargeable against, the amounts so excluded from gross income.

§ 1.934-1 Limitation on reduction in income tax liability incurred to the Virgin Islands.

(a) *General rule.* Section 934(a) provides that tax liability incurred to the Virgin Islands shall not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in section 934 (b) or (c). For purposes of the preceding sentence, the term "tax liability" means the liability incurred to the Virgin Islands pursuant to subtitle A of the Code, as made applicable in the Virgin Islands by the Act of July 12, 1921 (48 U.S.C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642).

(b) *Exception for certain domestic and Virgin Islands corporations*—(1) *General rule.* Section 934(b) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands by a domestic or Virgin Islands corporation for any taxable year (or for such part of such year as may be applicable) to the extent that such tax liability is attributable to income derived from sources without the United States, if such corporation satisfies the conditions provided in section 934(b) (1) and (2), and if the information required by section 934(d) is supplied. These conditions are enumerated in the remainder of this paragraph, and the information requirement is set forth in paragraph (d) of this section.

(2) *Conditions to be satisfied for exception.* A domestic or Virgin Islands corporation satisfies the conditions of section 934(b) (1) and (2) if—

(i) Eighty percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within the Virgin Islands; and

(ii) Fifty percent or more of the gross income of such corporation for such period (or such part thereof) was derived from the active conduct of a trade or business within the Virgin Islands.

(3) *Computation rule.* Except as provided in subparagraph (5) of this paragraph, tax liability incurred to the Virgin Islands by a domestic or Virgin Islands corporation for the taxable year (or such part of such year as may be applicable) attributable to income derived from sources without the United States shall be computed as follows:

(i) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under section 901(a);

(ii) Multiply by taxable income from sources without the United States for the applicable period;

(iii) Divide by total taxable income for the period;

(iv) Subtract any credit against the tax allowed under section 901(a). Tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States, as computed in this subparagraph, however, shall not exceed the total amount of income tax liability actually incurred.

(4) *Examples.* The rule of the preceding subparagraph may be illustrated by the following examples:

Example (1). Corporation X, which satisfies the requirements of section 934(b), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $290, as follows:

Taxable income from sources within the U.S	$200	
Taxable income from sources without the U.S	800	
Total taxable income		$1,000
Credit allowed under section 901(a)		10
Tax liability incurred to the Virgin Islands		290
The income tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States is $230, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	290	
Plus credit allowed under section 901(a)	10	
		300
(ii) Multiply by taxable income from sources without the U.S	800	
		240,000
(iii) Divide by total taxable income	1,000	
		240
(iv) Subtract credit allowed under section 901(a)	10	
		230

Example (2). Corporation Y, which satisfies the requirements of section 934(b), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $140, as follows:

Taxable income from sources within the U.S	($300 net loss)	
Taxable income from sources without the U.S	800	
Total taxable income		500
Credit allowed under section 901(a)		10
Tax liability incurred to the Virgin Islands		140
The income tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States is 140, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	140	
Plus credit allowed under section 901(a)	10	
		150
(ii) Multiply by taxable income from sources without the U.S	800	
		120,000
(iii) Divide by total taxable income	500	
		240
(iv) Subtract credit allowed under section 901(a)	10	
		230

Since the $230 derived from the computation is in excess of the actual tax liability incurred, the income tax liability incurred to the Virgin Islands attributable to income derived from sources without the United States is limited to $140, the actual liability incurred.

(5) *Special computation rule for certain domestic corporations.* For purposes of section 934(b) and this paragraph, tax liability incurred to the Virgin Islands by a domestic corporation which is required to file an income tax return with the United States for the taxable year (or such part of such year as may be applicable) attributable to income derived from sources without the United States shall be the actual income tax liability incurred to the Virgin Islands for such year.

(6) *Source of income.* For purposes of section 934(b) and this paragraph, the income of a Virgin Islands corporation, and the sources from which the income of such corporation is derived, shall be determined as if such corporation were a domestic corporation. However, all amounts received by a corporation within the United States, whether derived from sources within or without the United States, shall be considered as being derived from sources within the United States. In determining the sources from which the income of a domestic or Virgin Islands corporation is derived, the principles of part 1 (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder shall apply.

(c) *Exception for certain residents of the Virgin Islands*—(1) *General rule.* Section 934(c) provides another exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to the tax liability incurred by an individual citizen of the United States to the Virgin Islands for any taxable year to the extent that such tax liability is attributable to income derived from sources within the Virgin Islands, if such individual is a bona fide resident of the Virgin Islands during the entire taxable year and if he supplies the information required under section 934(d).

(2) *Definition—bona fide resident and United States citizen.* In determining whether a United States citizen is a bona fide resident of the Virgin Islands, the principles of §§ 1.871-2, 1.871-3, 1.871-4, and 1.871-5, relating to the determination of residence and nonresidence in the United States, shall apply. Once a bona fide residence in the Virgin Islands is established by an individual, temporary absence therefrom will not necessarily deprive such individual of his status as a bona fide resident of the Virgin Islands. For purposes of section 934(c), a citizen of the United States includes any individual who is a citizen of the United States by reason of being a citizen of any possession of the United States.

(3) *Computation rule.* For purposes of section 934(c) and this paragraph, tax liability incurred to the Virgin Islands for the taxable year attributable to income derived from sources within the Virgin Islands shall be computed as follows:

(i) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under section 901(a);

(ii) Multiply by taxable income from sources within the Virgin Islands;

(iii) Divide by total taxable income. Tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands, as computed in this subparagraph, however, shall not exceed the total amount of income tax liability actually incurred.

(4) *Examples.* The rule of the preceding subparagraph may be illustrated by the following examples:

Example (1). A, an individual who satisfies the requirements of section 934(c), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $380, as follows:

Taxable income from sources within the Virgin Islands	$1,200	
Taxable income from sources without the Virgin Islands	800	
Total taxable income		2,000
Credit allowed under section 901(a)		20
Tax liability incurred to the Virgin Islands		380

The income tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands is $240, computed as follows:

(i) Tax liability incurred to the Virgin Islands	380	
Plus credit allowed under section 901(a)	20	
		400
(ii) Multiply by taxable income from sources within the Virgin Islands	1,200	
		480,000
(iii) Divide by total taxable income		2,000
		240

Example (2). B, an individual who satisfies the requirements of section 934(c), incurs an income tax liability to the Virgin Islands for taxable year 1963 of $100, as follows:

Taxable income from sources within the Virgin Islands	$800	
Taxable income from sources without the Virgin Islands	(200 net loss)	
Total taxable income		600
Credit allowed under section 901(a)		20
Tax liability incurred to the Virgin Islands		100
The income tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands is $100, computed as follows:		
(i) Tax liability incurred to the Virgin Islands	100	
Plus credit allowed under section 901(a)	20	
		120
(ii) Multiply by taxable income from sources within the Virgin Islands	800	
		96,000
(iii) Divide by total taxable income	600	
		160

Since the $160 derived from the computation is in excess of the actual tax liability incurred, the income tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands is limited to $100, the actual liability incurred.

(5) *Source of income.* For purposes of section 934(c) and this paragraph, in determining taxable income from sources within and without the Virgin Islands the principles of part 1 (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder shall apply, except that—

(i) Any deductions for personal exemptions allowable under section 151 shall be deducted in computing taxable income from sources within the Virgin Islands but shall not be deducted in computing taxable income from sources without the Virgin Islands;

(ii) Amounts received for services performed as an employee of the United States or any agency thereof shall not be considered as income derived from sources within the Virgin Islands;

(iii) Gain or loss from the sale or exchange of any security (as defined in section 165(g)(2)) shall not be treated as derived from sources within the Virgin Islands.

(6) *Definition—"taxable income" on a joint return.* In the case of a husband and wife making a joint return, the term "taxable income", as used in this paragraph, means the combined taxable income of both spouses.

(d) *Information required.* Section 934(d) provides that the exceptions in section 934 (b) and (c) shall apply only in the case of persons who supply such information as the Secretary or his delegate may by regulations prescribe for purposes of determining the applicability of such exceptions. The following portions of this paragraph, together with paragraphs (e) and (f) of this section, prescribe the information which must be filed. Any person seeking to come within an exception must provide the following information:

(1) The name and address of such person;

(2) If such person is one of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests within the meaning of section 482 and the regulations thereunder—

(i) The name and address of each such organization, trade, or business;

(ii) The relationship which each such organization, trade, or business bears to the other organizations, trades, or businesses in such group;

(iii) The nature of the activity or activities conducted by each such organization, trade, or business.

(3) Any person seeking to come within an exception must make available for inspection by the Director of International Operations such records, and underlying contracts and documents, as are necessary to determine the applicability of section 934(b) or (c).

(e) *Information required—corporations.* Corporations seeking to come within the exception provided in section 934(b) shall, in addition to the information required by paragraph (d) of this section, submit the following information with respect to each taxable year:

(1) The date and place of incorporation;

(2) The name and address of any shareholder of record owning at any time during the taxable year 5 percent or more of the voting stock of any class or 5 percent or more of the value of any class of outstanding stock, and the nature and amount of the stock owned;

(3) For the 3-year period immediately preceding the close of the corporation's taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable)—

(i) The total amount of its gross income;

(ii) The amount of such gross income derived from the active conduct of a trade or business within the Virgin Islands;

(iii) The amount of such gross income from sources within (*a*) the Virgin Islands, (*b*) the United States (including therein and specifically itemizing all amounts received within the United States), and (c) all other countries as a group;

(iv) The ratio which gross income derived from sources within the Virgin Islands bears to total gross income;

(v) The ratio which gross income derived from the active conduct of a trade or business within the Virgin Islands bears to total gross income.

(f) *Information required—individuals.* Individuals seeking to come within the exception provided in section 934(c) shall, in addition to the information required by paragraph (d) of this section, submit the following information with respect to each taxable year:

(1) The date on which such individual became a bona fide resident of the Virgin Islands;

(2) If such individual maintains a place of abode for himself or his family in the United States or elsewhere outside the Virgin Islands, the location of such place of abode and the purpose for which such place is maintained;

(3) The beginning and the ending dates of each period of absence from the Virgin Islands during such taxable year;

(4) The amount of gross income for such taxable year from sources within the Virgin Islands, excluding—

(i) The amount of gain or loss from the sale or exchange of any security, as defined in section 165(g)(2);

(ii) The amount of gross income received for services performed as an employee of the United States or any agency thereof:

(5) Any amounts excluded from gross income from sources within the Virgin Islands under subparagraph (4) (i) and (ii) of this paragraph.

(g) *Time and place for filing statement.* The statement, in duplicate, providing the information required under section 934(d) and paragraphs (d), (e), and (f) of this section shall be attached to the income tax return filed with the Government of the Virgin Islands for the taxable year with respect to which an exception is claimed under section 934 (b) or (c). If an exception is claimed with respect to any taxable year for which the time prescribed by law for filing the return expires prior to 30 days from the publication of these regulations, the required statement must be filed in duplicate on or before 90 days from the publication of these regulations. The return and statement must be available for examination by the Director of International Operations.

(h) *Effective date.* The provisions of this section shall apply to taxable years beginning after December 31, 1959.

[T.D. 6629, 27 FR 12791, Dec. 28, 1962]

§ 1.935-1 Coordination of U.S. and Guam individual income taxes.

(a) *Application of section*—(1) *Scope.* Section 935 and this section set forth the special rules relating to the filing of income tax returns, income tax liabilities, and estimated income tax of individuals described in subparagraph (2) of this paragraph. For additional rules relating to the collection of income tax at source on the wages of certain individuals, the furnishing of certain information with the returns of certain individuals, and the covering over to the treasury of Guam of net collections of income taxes imposed on certain individuals, see section 7654 and § 301.7654-1 of this chapter (Regulations on Procedure and Administration).

(2) *Individuals covered.* This section shall apply for a taxable year to any individual who—

(i) Is a resident of Guam, whether or not he is a citizen of the United States,

(ii) Is a citizen of Guam but not otherwise a citizen of the United States,

(iii) Has income derived from Guam for the taxable year and is a citizen or resident of the United States, or

(iv) Files a joint return for the taxable year with any individual described in subdivision (i), (ii), or (iii) of this subparagraph.

(3) *Determination of residence and citizenship.* For purposes of this section, determinations of residence and citizenship for a taxable year shall be made (except as provided to the contrary in paragraph (d) (1) and (2) of this section) as of the close of the taxable year. A citizen of the United States is any individual who is a citizen within the meaning of paragraph (c) of § 1.1-1, except that the term does not include an individual who is a citizen of Guam but not otherwise a citizen of the United States. An individual who is a citizen of Guam but not otherwise a citizen of the United States is any individual who has become a citizen of the United States by birth or naturalization in Guam. Whether an individual is a resident of Guam or a resident of the United States shall generally be determined by applying to the facts and circumstances in each case the principles of §§ 1.871-2 through 1.871-5 relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual. However, for special rules for determining the residence for tax purposes of individuals under military or naval orders, see section 514 of the Soldiers' and Sailors' Civil Relief Act of 1940, 50 App. U.S.C. 574. The residence of an individual, and, therefore, the jurisdiction with which he is required to file an income tax return under paragraph (b) of this section, may change from year to year.

(b) *Filing requirement*—(1) *Tax Jurisdiction.* An individual described in paragraph (a)(2) of this section shall file his return of income tax for the taxable year—

(i) With the United States if he is a resident of the United States, whether or not he is a citizen of the United States,

(ii) With Guam if he is a resident of Guam, whether or not he is a citizen of Guam, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies,

(A) With Guam if he is a citizen of Guam but not otherwise a citizen of the United States, as defined in paragraph (a) (3) of this section, or

(B) With the United States if he is a citizen of the United States, as defined in paragraph (a)(3) of this section. Thus, for example, if a U.S. citizen employed by the United States in Guam becomes a resident of Guam for the taxable year, he must file his return of income tax for such year with Guam. The tax shown on the return shall be paid to the jurisdiction with which such return is required to be filed and shall be determined by taking into account any credit under section 31 for tax withheld by Guam or the United States on wages, any credit under section 6402(b) for an overpayment of income tax to Guam or the United States, and any payments under section 6315 of estimated income tax paid to Guam or the United States. See paragraph (a)(3) of this section for the rule that determinations of residence and citizenship are to be made as of the close of the taxable year.

(2) *Joint returns.* In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses shall file their joint return with, and pay the tax due on such return to, the jurisdiction where the spouse who has the greater adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his return if separate returns were filed. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations thereunder but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse shall

be treated as ending on the date of such death.

(3) *Place for filing returns*—(i) *U.S. returns.* A return required under this paragraph to be filed with the United States shall be filed in accordance with § 1.6091-2, except that such return of a citizen or resident of the United States who is described in § 301.7654-1(a)(2) of this chapter (Regulations on Procedure and Administration) shall be filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155.

(ii) *Guam returns.* A return required under this paragraph to be filed with Guam shall be filed with the Commissioner of Revenue and Taxation, Agana, Guam 96910.

(4) *Tax accounting standards.* A taxpayer who has filed his return with one of the jurisdictions named in subparagraph (1) of this paragraph for a prior taxable year and is required to file his return for a later taxable year with the other such jurisdiction may not, for such later taxable year, change his accounting period, method of accounting, or any election to which he is bound with respect to his reporting of taxable income to the first jurisdiction unless he obtains the consent of the second jurisdiction to make such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing he also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this subparagraph must be made to the office where the return is required to be filed under subparagraph (3) of this paragraph and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(c) *Extent of liability for income tax*—(1) *Extension of territory*—(i) *General rule.* With respect to an individual who, for a taxable year, is described in paragraph (a) (2) of this section—

(A) For purposes of so much of the Internal Revenue Code of 1954 as relates to the normal taxes and the surtaxes imposed by chapter 1 thereof, the United States shall be treated, in a geographical and governmental sense, as including Guam, and

(B) For purposes of the Guam Territorial income tax (48 U.S.C. 1421i), Guam shall be treated, in a geographical and governmental sense, as including the United States except that this subdivision shall not apply for purposes of this section, section 7651, and section 7654.

(ii) *Application of general rule.* (A) The significance of the application of the rule of subdivision (i) of this subparagraph will depend upon the facts and circumstances of the particular case. The rule will not be applied where its application would be manifestly inapplicable or incompatible with the intent thereof. Thus, the rule will not be applied for purposes of section 3401, relating to definition of wages. Also, the rule will not be applied in determining the sources of dividends and interest from a domestic corporation. For example, if less than 20 percent of a domestic corporation's gross income is from U.S. sources for the period described in section 861(a)(1)(B) and (2)(A), but more than 20 percent of its gross income is from U.S. and Guam sources taken together for such period, the dividends and interest derived from it will be treated as derived from sources without the United States. In addition, for purposes of section 1372(e)(4), relating to whether an election of a small business corporation has been terminated because it derived more than 80 percent of its gross receipts from sources outside the United States, gross receipts from sources within Guam will be treated as gross receipts from sources outside the United States. On the other hand, some of the conclusions which may be reached as a result of the application of subdivision (i) of this subparagraph to a U.S. taxpayer (that is, an individual described in paragraph (b)(1) (i) or (iii)(B) of this section) are as follows. A U.S. taxpayer may not claim a foreign tax credit based upon his income from sources within Guam. Income tax paid to Guam may be taken into account under sections 31, 6315, and 6402(b) as payments to the United States. For purposes of section 116(a), relating to the partial exclusion of dividends received by individuals, dividends paid to a U.S. taxpayer by a corporation created or organized in Guam or under the law of Guam will be treated as dividends paid by a domestic corporation. Taxes paid to Guam and otherwise satisfying the requirements of section 164(a) will be allowed as a deduction under that section, but income taxes paid to Guam will be disallowed as a deduction under section 275(a).

(B) If a U.S. taxpayer has a net operating loss carryback or carryover under section 172, a foreign tax credit carryback or carryover under section 904, an investment credit carryback or carryover under section 46, a capital loss carryover under section 1212, or a charitable contributions carryover under section 170, the United States will take such carryback or carryover into account for a taxable year for which the taxpayer's return is required to be filed with the United States, and make a refund to the extent required under section 6402, even though the return of the taxpayer for the taxable year (whether beginning on, before, or after December 31, 1972) giving rise to the carryback or carryover was required to be filed with Guam.

(C) For purposes of income averaging of a U.S. taxpayer under sections 1301 through 1305, the taxpayer will not be denied status as an "eligible individual" merely because he was during the base period defined in section 1302(c)(2) treated under section 932 as a nonresident alien individual because he was a citizen of Guam but not otherwise a citizen of the United States. See section 1303(b). Furthermore, in determining the base period of such a U.S. taxpayer under section 1302(c)(2), taxable years for which a return was required to be filed with Guam shall be taken into account.

(D) In applying the Guam Territorial income tax the converse of the preceding rules under this subdivision will apply. Thus, for example, income tax paid to the United States may be taken into account under sections 31, 6315, and 6402(b) as payments to Guam. Moreover, a citizen of the United States (as defined in paragraph (a)(3) of this section) not a resident of Guam will not be treated as a nonresident alien individual for purposes of the Guam Territorial income tax. Thus, for example, a citizen of the United States (as so defined), or a resident of the United States, will not be treated as a nonresident alien individual for purposes of section 1371(a)(3) of the Guamanian Territorial income tax.

(2) *Liability to other jurisdiction*—(i) *Filing with Guam.* If for a taxable year an individual is required under paragraph (b)(1) of this section to file a return with Guam, he is relieved of liability to file an income tax return with, and to pay an income tax to, the United States for the taxable year.

(ii) *Filing with the United States.* If for a taxable year an individual is required under paragraph (b)(1) of this section to file a return with the United States, he is relieved of liability to file an income tax return with, and to pay an income tax to, Guam for the taxable year.

(d) *Special rules for estimated income tax*—(1) *Declaration of estimated income tax.* If, under all the facts and circumstances existing at the date an individual is required to file a declaration of estimated income tax, there is reason to believe that he will, for the taxable year, be an individual described in paragraph (a)(2) of this section, he must file his declaration of estimated income tax (and all amendments thereof) with the jurisdiction with which he would be required to file a return under paragraph (b)(1) of this section if his taxable year had closed on the date he is first required to file a declaration of estimated income tax for the taxable year. Except as provided in paragraph (6) of this section (relating to underpayments of estimated income tax), payments of estimated income tax shall be made to the jurisdiction with which he is required to file the declaration even though for the taxable year he is required under paragraph (b)(1) of this section to file his return with the other jurisdiction. In determining the amount of such estimated income tax, income tax paid to Guam may be taken into account under sections 31 and 6402(b) as payments to the United States, and vice versa. For rules relating to the determination of, and time for filing, declarations of estimated tax, see sections 6015 and 6073; for rules relating to the time for paying installments of the tax, see section 6153.

(2) *Joint declaration of estimated income tax.* In the case of married persons, if, under all the facts and circumstances existing at the date a spouse is required to file a declaration of estimated income tax, there is reason to believe that he will, for the taxable year, be an individual described in paragraph (a)(2) of this section and the spouses file a joint declaration of estimated income tax, the spouses must file their joint declaration of estimated income tax (and all amendments thereof) with the jurisdiction where the spouse who has the greater estimated adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his declaration of estimated income tax if separate declarations were filed. For this purpose, estimated adjusted gross income of each spouse for the taxable year is determined without regard to community property laws. Except as provided in paragraph (6) of this section, payments of estimated income tax shall be made to the jurisdiction with which the spouses are required to file the joint declaration.

(3) *Early filing of declarations.* If the individual or spouses have in fact filed a declaration or joint declaration of estimated income tax earlier than the time he or they are first required to file the declaration and such declaration was not filed where it is required to be filed under paragraph (d) (1) or (2) of this section, as the case may be, of this paragraph, only subsequent amendments of the declaration are required to be filed pursuant to such paragraph (d) (1) or (2) of this section with the other jurisdiction and only susequent installments of the estimated income tax are required to be paid to the other jurisdiction.

(4) *Place for filing declarations.* A declaration of estimated income tax required under subparagraph (1) of this paragraph to be filed with Guam, shall be filed as prescribed in paragraph (b)(3)(ii) of this section. A declaration of estimated income tax required under subparagraph (1) of this paragraph to be filed with the United States shall be filed at the place prescribed by § 1.6073-1(c).

(5) *Liability to other jurisdiction*—(i) *Filing with Guam.* If, for a taxable year, an individual is required under this paragraph to file a declaration of estimated income tax with Guam, he is relieved of liability to file a declaration of estimated income tax (and any amendments thereof) with, and to make payments of estimated income tax to, the United States for the taxable year.

(ii) Filing with the United States. If, for a taxable year, an individual is required under this paragraph to file a declaration of estimated income tax with the United States, he is relieved of liability to file a declaration of estimated income tax (and any amendments thereof) with, and to make payments of estimated income tax to, Guam for the taxable year.

(6) *Underpayments.* The liability of an individual described in paragraph (a)(2) of this section for underpayments of estimated income tax for a taxable year, as determined under section 6654 and the regulations thereunder, shall be to the jurisdiction with which he is required under paragraph (b) of this section to file his return for the taxable year.

(e) *Illustration.* The application of this section may be illustrated by the following examples:

Example (1). B, and individual, files returns on a calendar year basis. B is a resident of the United States at the time he is required to file his declaration of estimated income tax for 1974. If, under the facts and circumstances, B does not reasonably expect at the time he files his declaration of estimated income tax that he will be a resident of Guam at the close of 1974, he will not be subject to this section at the time of such filing. However, B subsequently receives Guam source income which necessitates an amendment of his declaration, and some time later in 1974 he becomes a resident of Guam for the remainder of the year. B is required under paragraph (d)(1) of this section to file his amended declaration with the United States and to make payments of the estimated tax to the United States. However, B is required to file his income tax return for 1974 with Guam and to make any underpayments of estimated tax to Guam, pursuant to paragraphs (b)(1) and (d)(6) of this section.

Example (2). C, an individual, files returns on a calendar year basis. On March 1, 1974, C is a resident of the United States, files his declaration of estimated income tax for 1974 with the United States, and pays his first installment of estimated tax to the United States. Prior to the date C would otherwise be required to file his declaration of estimated income tax for 1974 (April 15, 1974), C becomes a resident of Guam for the remainder of the year. C is required under paragraph (d)(1) of this section to make only his remaining payments of installments of estimated tax to Guam. C is also required to file his income tax return for 1974 with Guam and to make any underpayments of estimated tax to Guam, pursuant to paragraphs (b)(1) and (d)(6) of this section.

Example (3). D, an individual, files returns on a calendar year basis. On August 1, 1974, D ceases to be a resident of the United States for the year and becomes a resident of Guam for the remainder of the year. D is first required to file a declaration of estimated income tax for 1974 on September 15, 1974, because of his receipt of an extraordinary item of income after June 15, 1974. D is required under paragraph (d)(1) of this section to file his declaration with Guam and to make payments of the estimated tax to Guam. D is also required to file his income tax return for 1974 with Guam and to make any underpayments of estimated tax to Guam, pursuant to paragraphs (b)(1) and (d)(6) of this section.

(f) *Effective date.* This section shall apply for taxable years beginning after December 31, 1972.

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (e)) of the Internal Revenue Code of 1954)

[T.D. 7385, 40 FR 50261, Oct. 29, 1975]

§ 1.936-1 Elections.

(a) *Making an election.* A domestic corporation shall make an election under section 936(e), for any taxable year beginning after December 31, 1975, by filing Form 5712 on or before the later of—

(1) The date on which such corporation is required, pursuant to sections 6072(b) and 6081, to file its Federal income tax return for the first taxable year for which the election is made; or

(2) April 8, 1980.

Form 5712 shall be filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155 (Philadelphia Center).

(b) *Revoking an election.* Any corporation to which an election under section 936 (e) applies on February 8, 1980 is hereby granted the consent of the Secretary to revoke that election for the first taxable year to which the election applied. (The corporation may make a new election under § 1.936-1 (a) for any subsequent taxable year.) The corporation shall make this revocation by sending to the Philadelphia Center a written statement of revocation on or before April 8, 1980.

(Secs. 7805 and 936(e) of the Internal Revenue Code of 1954 (68A Stat. 917 and 90 Stat. 1644; 26 U.S.C. 7805 and 936(e)))

[T.D. 7673, 45 FR 8588, Feb. 8, 1980; T.D. 7673, 45 FR 16174, Mar. 13, 1980]

CHINA TRADE ACT CORPORATIONS

§ 1.941-1 Special deduction for China Trade Act corporations.

In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

§ 1.941-2 Meaning of terms used in connection with China Trade Act corporations.

(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U.S.C., ch. 4).

(b) The term "special dividend" means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) "Taxable income derived from sources within Formosa and Hong Kong" is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated to sources within Formosa and Hong Kong. The method of computing this income is similar to that described in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

§ 1.941-3 Illustration of principles.

The application of section 941 may be illustrated by the following example:

Example. (1) The A Company, a China Trade Act corporation, has taxable income (computed without regard to the deduction under section 941) for the calendar year 1954 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1954, is owned on that date by persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, or individual citizens of the United States. It distributes a special dividend amounting to $100,000 on February 15, 1955, which is certified by the Secretary of Commerce as provided in section 941(b). For the purpose of the tax imposed by section 11, it is necessary in this example to make two computations, first, without allowing the special deduction from taxable income on account of income derived from sources within Formosa and Hong Kong, and, second, allowing such deduction. The computations are as follows:

(2) First computation; without allowing the special deduction from taxable income.

Taxable income	$200,000
Normal tax (section 11 (b))	60,000
Surtax (section 11 (c))	38,500
Total income tax	98,500

(3) Second computation; allowing the special deduction from taxable income.

Taxable income	$200,000

Since the total taxable income is derived from sources within Formosa and Hong Kong and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of such taxable income is deductible.

Special deduction from taxable income	$200,000
Amount of income subject to tax under section 11	None

(4) Since the special dividend ($100,000) exceeds the diminution of the tax ($98,500) on account of the allowance of the special deduction from taxable income, the entire amount of the special deduction is allowable and the corporation has no income tax liability for 1954.

§ 1.943-1 Withholding by a China Trade Act corporation.

Dividends paid by a China Trade Act corporation to a nonresident alien individual, foreign partnership, or foreign corporation are subject to withholding of tax at source under § 1.1441-1. However, see paragraph (c) of § 1.1441-4 for exemption applicable to dividends paid to residents of Formosa or Hong Kong.

[T.D. 6908, 31 FR 16769, Dec. 31, 1966]

CONTROLLED FOREIGN CORPORATIONS

§ 1.951-1 Amounts included in gross income of United States shareholders.

(a) *In general.* If a foreign corporation is a controlled foreign corporation (within the meaning of section 957) for an uninterrupted period of 30 days or more (determined under paragraph (f) of this section) during any taxable year of such corporation beginning after December 31, 1962, every person—

(1) Who is a United States shareholder (as defined in section 951(b) and paragraph (g) of this section) of such corporation at any time during such taxable year, and

(2) Who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends, the sum of—

(i) Except as provided in section 963, such shareholder's pro rata share (determined under paragraph (b) of this section) of the corporation's Subpart F income (as defined in section 952) for such taxable year of the corporation,

(ii) Such shareholder's pro rata share (determined under paragraph (c) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such taxable year of the corporation, and

(iii) Such shareholder's pro rata share (determined under paragraph (d) of this section) of the corporation's increase in earnings invested in United States property for such taxable year of the corporation (but only to the extent such pro rata share is not excluded from such shareholder's gross income for his taxable year under section 959(a)(2)).

For purposes of determining whether a United States shareholder which is a domestic corporation is a personal holding company under section 542 and § 1.542-1, the character of the amount includible in gross income of such domestic corporation under this paragraph shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the controlled foreign corporation. See paragraph (a) of § 1.957-2 for special limitation on the amount of subpart F income in the case of a controlled foreign corporation described in section 957(b). See section 970(a) and § 1.970-1 which provides for the reduction of subpart F income of export trade corporations.

(b) *Limitation on a United States shareholder's pro rata share of subpart F income*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's subpart F income for the taxable year of such corporation is—

(i) The amount which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in such corporation's taxable year, on which such corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount which bears the same ratio to its subpart F income for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year, reduced by—

(ii) The amount of distributions received by any other person during such taxable year as a dividend with respect to such stock, but only to the extent that such distributions do not exceed the dividend which would have been received by such other person if the distributions by such corporation to all its shareholders had been the amount which bears the same ratio to the subpart F income of such corporation for the taxable year as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire taxable year.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). A, a United States shareholder, owns 100 percent of the only class of stock of M, a controlled foreign corporation throughout 1963. Both A and M Corporation use the calendar year as a taxable year. For 1963, M Corporation derives $100 of subpart F income, has $100 of earnings and profits, and makes no distributions. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i).

Example (2). The facts are the same as in example (1), except that instead of holding 100 percent of the stock of M Corporation for the entire year, A sells 60 percent of such stock to B, a nonresident alien, on May 26, 1963. Thus, M Corporation is a controlled foreign corporation for the period January 1, 1963, through May 26, 1963. A must include $40 ($100×146/365) in his gross income for 1963 under section 951(a)(1)(A)(i).

Example (3). The facts are the same as in example (1), except that instead of holding 100 percent of the stock of M Corporation for the entire year, A holds 60 percent of such stock on December 31, 1963, having acquired such interest on May 26, 1963, from B, a nonresident alien, who owned such interest from January 1, 1963. Before A's acquisition of such stock, M Corporation had distributed a dividend of $15 to B in 1963 with respect to such stock. A must include $21 in his gross income for 1963 under section 951(a) (1)(A)(i), such amount being determined as follows:

Corporation M's subpart F income for 1963		$100
Less: Reduction under sec. 951(a)(2) (A) for period (1-1-63 through 5-26-63) during which M Corporation is not a controlled foreign corporation ($100 × 146/365)		40
Subpart F income for 1963 as limited by sec. 951(a)(2)(A)		60
A's pro rata share of subpart F income as determined under sec. 951 (a)(2)(A) (60 percent of $60)		36
Less: Reduction under sec. 951(a)(2) (B) for dividends received by B during 1963 with respect to the stock acquired by A in M Corporation:		
(i) Dividend received by B	15	
(ii) B's pro rata share of the amount which bears the same ratio to M Corporation's subpart F income for 1963 ($100) as the period during which A did not own (within the meaning of sec. 958(a)) his stock (146 days) bears to the entire taxable year (365 days) (60 percent of ($100 × 146/365))	24	
(iii) Amount of reduction (lesser of (i) or (ii))		15
A's pro rata share of subpart F income as determined under sec. 951(a)(2)		21

Example (4). A, a United States shareholder, owns 100 percent of the only class of stock of P, a controlled foreign corporation throughout 1963, and P owns 100 percent of the only class of stock of R, a controlled foreign corporation throughout 1963. A and Corporations P and R each use the calendar year as a taxable year. For 1963, R Corporation derives $100 of Subpart F income, has $100 of earnings and profits, and distributes a dividend of $20 to P Corporation. Corporation P has no income for 1963 other than the dividend received from R Corporation. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i) as Subpart F income of R Corporation for such year. Such Subpart F income is not reduced under sec. 951(a)(2)(B) for the dividend of $20 paid to P Corporation because there was no part of the year 1963 during which A did not own (within the meaning of section 958(a)) the stock of R Corporation. By reason of the application of section 959(b), the $20 distribution from R Corporation to P Corporation is not again includible in the gross income of A under section 951(a).

Example (5). The facts are the same as in example (4), except that instead of holding the stock of R Corporation for the entire year, P Corporation acquires 60 percent of the only class of stock of R Corporation on March 14, 1963, from C, a nonresident alien, after R Corporation distributes in 1963 a dividend of $35 to C with respect to the stock so acquired by P Corporation. The stock interest so acquired by P Corporation was owned by C from January 1, 1963, until acquired by P Corporation. A must include $36 in his gross income for 1963 under section 951(a) (1)(A)(i), such amount being determined as follows:

Corporation R's subpart F income for 1963		$100
Less: Reduction under sec. 951(a)(2)(A) for period (1-1-63 through 3-14-63) during which R Corporation is not a controlled foreign corporation ($100 × 73/365)		20
Subpart F income for 1963 as limited by sec. 951(a)(2)(A)		80
A's pro rata share of subpart F income as determined under sec. 951 (a)(2)(A) (60 percent of $80)		48
Less: Reduction under sec. 951(a)(2)(B) for dividends received by C during 1963 with respect to the stock indirectly acquired by A in R Corporation:		
(i) Dividend received by C	35	

(ii) C's pro rata share of the amount which bears the same ratio to R Corporation's subpart F income for 1963 ($100) as the period during which A did not indirectly own (within the meaning of section 958(a)(2)) his stock (73 days) bears to the entire taxable year (365 days) (60 percent of ($100×73/365))	12	
(iii) Amount of reduction (lesser of (i) or (ii))		12
A's pro rata share of subpart F income as determined under sec. 951 (a)(2)		36

(c) *Limitation on a United States shareholder's pro rata share of previously excluded subpart F income withdrawn from investment.* For purposes of paragraph (a)(2) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3) and paragraph (c) of § 1.955-1) for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of § 1.955-1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(d) *Limitation on a United States shareholder's pro rata share of increase in investment in United States property.* For purposes of paragraph (a)(3) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's increase in earnings invested in United States property for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such increase (as determined under section 956(a)(2) and paragraph (c) of § 1.956-1) for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. The amount determined under the preceding sentence, however, shall be taken into account under paragraph (a)(3) of this section only to the extent such amount is not excluded from such shareholder's gross income for his taxable year under section 959(a)(2) and the regulations thereunder.

(e) *"Pro rata share" defined*—(1) *In general.* For purposes of paragraphs (b), (c), and (d) of this section, a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, or increase in earnings invested in United States property, respectively, for any taxable year is his pro rata share determined under paragraph (a) of § 1.952-1, paragraph (c) of § 1.955-1, or paragraph (c) of § 1.956-1, respectively.

(2) *More than one class of stock.* If a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income, withdrawal, or increase in investment, for the taxable year which shall be taken into account with respect to any one class of such stock for purposes of subparagraph (1) of this paragraph shall be that amount which bears the same ratio to the total of such subpart F income, withdrawal, or increase in investment for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation bear to the total earnings and profits of such corporation for such taxable year. For purposes of the preceding sentence, if an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962.

(3) *Discretionary power to allocate earnings to different classes of stock.* If the allocation of a foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the powers ordinarily exercised by the board of directors of a domestic corporation, the allocation of earnings and profits to such classes shall be made for purposes of this paragraph as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share, unless a different method of allocation of earnings and profits is established as proper by the United States shareholder.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Throughout its taxable year 1964, controlled foreign corporation A has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, nonvoting, preferred stock with a par value of $100 per share. D, a United States citizen who uses the calendar year as a taxable year, owns 30 shares of the common, and 15 shares of the preferred, stock during 1964: Corporation A for 1964 has earnings and profits of $1,000, and income of $500 with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In such case, if the total $1,000 of earnings and profits were distributed on December 31, 1964, $360 (0.06×$100×60) would be distributed with respect to A Corporation's preferred stock and $640 ($1,000 minus $360) would be distributed with respect to its common stock. Accordingly, of the $500 with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a), $180 ($360/$1,000× $500) is allocated to the outstanding preferred stock and $320 ($640/$1,000×$500) is allocated to the outstanding common stock. D's pro rata share of such amounts for 1964 is $285 [($180×15/60)+($320× 30/40)].

Example (2). The facts are the same as in example (1), except that the preferred stock is cumulative and there is an arrearage in dividends with respect to such stock of $900; on December 31, 1963, Corporation A has accumulated earnings and profits for 1963 of $700; therefore, for purposes of this paragraph, Corporation A's earnings and profits for 1964 attributable to such arrearage may not exceed $200 ($900 minus $700). In such case, for purposes of this paragraph, if the $1,000 earnings and profits for 1964 were distributed on December 31, 1964, $560 [(0.06×$100×60)+$200] would be distributed with respect to A Corporation's preferred stock and $440 ($1,000 minus $560) would be distributed with respect to its common stock. Accordingly, of the $500 with respect to which amounts are required to be included in gross income of United States shareholders under section 951 (a), $280 ($560/$1,000×$500) is allocated to the outstanding preferred stock and $220 ($440/$1,000×$500) is allocated to the outstanding common stock. D's pro rata share of such amounts for 1964 is $235 [($280×15/60)+($220×30/40)].

(f) *Determination of holding period.* For purposes of sections 951 through 964, the holding period of an asset (including stock of a controlled foreign corporation) shall be determined by excluding the day on which such asset is acquired and including the day on which such asset is disposed of. The application of this paragraph may be illustrated by the following example:

Example. On June 30, 1963, United States person E acquires 70 of the 100 shares of the only class of stock of foreign corporation A from nonresident alien B, who until such time owns all such 100 shares. E sells 10 shares of stock of such corporation on November 30, 1963, and 60 shares on December 31, 1963, to nonresident alien F. Corporation A is a controlled foreign corporation for the period beginning with July 1, 1963, and extending through December 31, 1963. As to the 10 shares of stock sold on November 30, 1963, E is treated as not owning such shares at any time after November 30, 1963, nor before July 1, 1963. As to the remaining 60 shares of stock, E is treated as not owning them before July 1, 1963, or after December 31, 1963.

(g) *United States shareholder defined*— (1) *In general.* For purposes of sections 951 through 964, the term "United States shareholder" means, with respect to a foreign corporation, a United States person (as defined in section 957(d)) who owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(2) *Percentage of total combined voting power owned by United States*

person—(i) *Meaning of combined voting power.* In determining for purposes of subparagraph (1) of this paragraph whether a United States person owns the requisite percentage of voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances in each case. In any case where—

(*a*) A foreign corporation has more than one class of stock outstanding, and

(*b*) One or more United States persons own (within the meaning of section 958) shares of any one class of stock which possesses the power to elect, appoint, or replace a person, or persons, who with respect to such corporation, exercise the powers ordinarily exercised by a member of the board of directors of a domestic corporation,

the percentage of the total combined voting power with respect to such corporation owned by any such United States person shall be his proportionate share of the percentage of the persons exercising the powers ordinarily exercised by members of the board of directors of a domestic corporation (described in (*b*) of this subdivision) which such class of stock (as a class) possesses the power to elect, appoint, or replace. In all cases, however, a United States person will be deemed to own 10 percent or more of the total combined voting power with respect to a foreign corporation if such person owns (within the meaning of section 958) 20 percent or more of the total number of shares of a class of stock of such corporation possessing one or more powers enumerated in paragraph (b)(1) of § 1.957-1. Whether a foreign corporation is a controlled foreign corporation for purposes of sections 951 through 964 shall be determined by applying the rules of section 957 and §§ 1.957-1 through 1.957-4.

(ii) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation S has two classes of capital stock outstanding, consisting of 60 shares of class A stock and 40 shares of class B stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any dividend distributions by S Corporation. The owners of a majority of the class A stock are entitled to elect 7 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 3 of the 10 directors. Thus, the class A stock (as a class) possesses 70 percent of the total combined voting power of all classes of stock entitled to vote of S Corporation, and the class B stock (as a class) possesses 30 percent of such voting power. D, a United States person, owns 31 shares of the class A stock and thus owns 36,167 percent (31/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, D is a United States shareholder of S Corporation under section 951(b). For purposes of section 957, S Corporation is a controlled foreign corporation by reason of D's ownership of a majority of the class A stock, as illustrated in example (2) of paragraph (c) of § 1.957-1. E, a United States person, owns eight shares of the class A stock and thus owns 9.333 percent (8/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. Since E owns only 9.333 percent of such voting power and less than 20 percent of the number of shares of the class A stock, he is not a United States shareholder of S Corporation under section 951(b). F, a United States person, owns 14 shares of the class B stock and thus owns 10.5 percent (14/40×30 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, F is a United States shareholder of S Corporation under section 951(b).

Example (2). Foreign corporation R has three classes of stock outstanding, consisting of 10 shares of class A stock, 20 shares of class B stock, and 300 shares of class C stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any distribution by R Corporation. The owners of a majority of the class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. The class C stock is not entitled to vote. D, E, and F, United States persons, each own 2 shares of the class A stock and 100 shares of the class C stock. As owners of a majority of the class A stock, D, E, and F elect 6 members of the board of directors. D, E, and F are United States shareholders of R Corporation under section 951(b) since each owns 20 percent of the total number of shares of the class A stock which possesses the power to elect a majority of the board of directors of R Corporation. For purposes of section 957, R Corporation is a controlled foreign corporation by reason of the ownership by D, E, and F of a majority of the class A stock, as illustrated in example (2) of paragraph (c) of § 1.957-1.

[T.D. 6795, 30 FR 935, Jan. 29, 1965]

§ 1.951-2 Coordination of subpart F with election of a foreign investment company to distribute income.

A United States shareholder who for his taxable year is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247(a) and the regulations thereunder is in effect for the taxable year of such company which ends with or within such taxable year of such shareholder shall not be required to include any amount in his gross income for his taxable year under paragraph (a) of § 1.951-1 with respect to such company for that taxable year of such company.

[T.D. 6795, 30 FR 937, Jan. 29, 1965]

§ 1.951-3 Coordination of subpart F with foreign personal holding company provisions.

A United States shareholder (as defined in section 951(b)) who is required under section 551(b) to include in his gross income for his taxable year his share of the undistributed foreign personal holding company income for the taxable year of a foreign personal holding company (as defined in section 552) which for that taxable year is a controlled foreign corporation (as defined in section 957) shall not be required to include in his gross income for his taxable year under section 951(a) and paragraph (a) of § 1.951-1 any amount attributable to the earnings and profits of such corporation for that taxable year of such corporation. If a foreign corporation is both a foreign personal holding company and a controlled foreign corporation for the same period which is only a part of its taxable year, then, for purposes of applying the immediately preceding sentence, such corporation shall be deemed to be, for such part of such year, a foreign personal holding company and not a controlled foreign corporation and the earnings and profits of such corporation for the taxable year shall be deemed to be that amount which bears the same ratio to its earnings and profits for the taxable year as such part of the taxable year bears to the entire taxable year. The application of this section may be illustrated by the following examples:

Example (1). A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation M which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation N. A and Corporations M and N use the calendar year as a taxable year. During 1963, N Corporation derives $40,000 of gross income all of which is foreign personal holding company income within the meaning of section 553; thus, N Corporation is a foreign personal holding company for such year within the meaning of section 552(a). For 1963, N Corporation has undistributed foreign personal holding company income (as defined in section 556(a)) of $30,000, derives $25,000 of subpart F income, and has earnings and profits of $32,000. During 1963, M Corporation derives $100,000 of gross income (including as a dividend under section 555(c)(2) the $30,000 of N Corporation's undistributed foreign personal holding company income), 65 percent of which is foreign personal holding company income within the meaning of section 553. Therefore, M Corporation is a foreign personal holding company for such year. For 1963, M Corporation has undistributed foreign personal holding company income (as defined in section 556(a)) of $90,000, determined by taking into account under section 552(c)(1) N Corporation's $30,000 of undistributed foreign personal holding company income for such year; in addition, M Corporation derives $50,000 of subpart F income and has earnings and profits of $92,000. Neither M Corporation nor N Corporation makes any actual distributions during 1963. A is required under section 551(b) to include in his gross income for 1963 as a dividend the $90,000 of M Corporation's undistributed foreign personal holding company income for such year. For 1963, A is not required to include in his gross income under section 951(a) any of the $50,000 subpart F income of M Corporation or of the $25,000 subpart F income of N Corporation.

Example (2). The facts are the same as in example (1), except that only 45 percent of M Corporation's gross income (determined by including under section 555(c)(2) the $30,000 of N Corporation's undistributed foreign personal holding company income) is foreign personal holding company income within the meaning of section 553; accordingly, M Corporation is not a foreign personal holding company for 1963. Since for such year M Corporation is not a foreign personal holding company, the undistributed foreign personal holding company income ($30,000) of N Corporation is not required under section 555(b) to be included in the gross income of M Corporation for 1963; as a result, such income is not required under section 551(b) to be included in the gross income of A for such year even though N Corporation is a foreign personal holding company for that year. For 1963, A is required to include $75,000 in his gross income under section 951(a)(1)(A)(i) and paragraph (a) of § 1.951-1, consisting of the $50,000 subpart F income of M Corporation and the $25,000 subpart F income of N Corporation.

Example (3). The facts are the same as in example (1), except that in 1963 N Corporation actually distributes $30,000 to M Corporation and M Corporation, in turn, actually distributes $90,000 to A. Under section 556 the undistributed foreign personal holding company income of both M corporation and N Corporation is thus reduced to zero; accordingly, no amount is included in the gross income of A under section 551(b) by reason of his interest in corporations M and N. A must include $75,000 in his gross income for 1963 under section 951(a)(1)(A)(i) and paragraph (a) of § 1.951-1, consisting of the $50,000 subpart F income of M Corporation and the $25,000 subpart F income of N Corporation. Of the $90,000 distribution received by A from M Corporation, $75,000 is excludable from his gross income under section 959(a)(1) as previously taxed earnings and profits; the remaining $15,000 is includible in his gross income for 1963 as a dividend.

Example (4). (a) A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation P, organized on January 1, 1963. Both A and P Corporation use the calendar year as a taxable year. During 1963, 1964, and 1965, P Corporation is not a foreign personal holding company as defined in section 552(a); in each of such years, P Corporation derives dividend income of $10,000 which constitutes foreign personal holding company income (within the meaning of § 1.954-2) but under paragraph (b)(1) of § 1.954-1 excludes such amounts from foreign base company income as dividends received from, and reinvested in, qualified investments in less developed countries. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(2) of § 1.955-1 are $40,000. For 1966, P Corporation is a foreign personal holding company, has predistribution earnings and profits of $10,000, derives $10,000 of income which is both foreign personal holding company income within the meaning of section 553 and subpart F income within the meaning of section 952, distributes $8,000 to A, and has undistributed foreign personal holding company income of $2,000 within the meaning of section 556. In addition, for 1966 P Corporation has a withdrawal (determined under section 955(a) but without regard to its earnings and profits for such year) of $25,000 of previously excluded subpart F income from investment in less developed countries. A is required under section 551(b) to include in his gross income for 1966 as a dividend the $2,000 undistributed foreign personal holding company income. The $8,000 distribution is includible in A's gross income for 1966 under sections 61(a)(7) and 301 as a distribution to which section 316(a)(2) applies. Corporation P's $25,000 withdrawal of previously excluded subpart F income from investment in less developed countries is includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of § 1.951-1.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $15,000, instead of $40,000, the result would be the same as in paragraph (a) of this example, except that a withdrawal of only $15,000 of previously excluded subpart F income from investment in less developed countries would be includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of § 1.951-1.

Example (5). (a) The facts are the same as in paragraph (a) of example (4), except that, instead of having a $25,000 decrease in qualified investments in less developed countries for 1966, P Corporation invests $20,000 in tangible property (not described in section 956(b)(2)) located in the United States and such investment constitutes an increase (determined under section 956(a) but without regard to the earnings and profits of P Corporation for 1966) in earnings invested in United States property. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(1) of § 1.956-1 are $22,000. The result is the same as in paragraph (a) of example (4), except that instead of including the $25,000 withdrawal, A must include $20,000 in his gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(3) of § 1.951-1 as an investment of earnings in United States property.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $9,000 instead of $22,000, the result would be the same as in paragraph (a) of this example, except that only $9,000 would be includible in A's gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(3) of § 1.951-1 as an investment of earnings in United States property.

[T.D. 6795, 30 FR 937, Jan. 29, 1965]

§ 1.952-1 Subpart F income defined.

(a) *In general.* For purposes of sections 951 through 964, a controlled foreign corporation's subpart F income for any taxable year shall, except as provided in paragraph (b) of this section and subject to the limitations of paragraphs (c) and (d) of this section, consist of the sum of—

(1) The income derived by such corporation for such year from the insurance of United States risks (determined in accordance with the provisions of section 953 and §§ 1.953-1 through 1.953-6), and

(2) The income derived by such corporation for such year which constitutes foreign base company income (determined in accordance with the provisions of section 954 and §§ 1.954-1 through 1.954-5).

Pursuant to section 951(a)(1)(A)(i) and § 1.951-1, a United States shareholder of such controlled foreign corporation must include his pro rata share of such subpart F income in his gross income for his taxable year in which or with which such taxable year of the foreign corporation ends. See section 952(a). However, see paragraph (a) of § 1.957-2 for special rule limiting the subpart F income to the income derived from the insurance of United States risks in the case of certain controlled foreign corporations described in section 957(b).

(b) *Exclusion of U.S. income*—(1) *Taxable years beginning before January 1, 1967*—(i) *In general.* Notwithstanding paragraph (a) of this section and except as provided in subdivision (ii) of this subparagraph, a controlled foreign corporation's subpart F income for any taxable year beginning before January 1, 1967, shall not include any item of income which is includible in the gross income of such corporation for such year under provisions (other than sections 951 through 964) of chapter 1 of the Code as income derived from sources within the United States if for the taxable year a tax is imposed with respect to such income in accordance with section 882(a). The deductions attributable to such items of gross income shall not be taken into account for purposes of section 952. Any item which is required to be excluded from gross income or which is taxed at a reduced rate under an applicable treaty obligation of the United States shall not be excluded from the gross income of a controlled foreign corporation under this subdivision. See section 952(b).

(ii) *Treatment of U.S. income of foreign insurance companies.* The subpart F income for any taxable year of a controlled foreign corporation beginning before January 1, 1967, which is a foreign insurance company, shall not include any item of income which is includible in the gross income of such corporation for such year under provisions (other than sections 951 through 964) of chapter 1 of the Code as income derived from sources within the United States if such income is described in section 819(a), 822(e), or 832(d) and, for such taxable year, a tax is imposed with respect to such income in accordance with section 802(a), 821(a), or 831(a), as the case may be. The deductions attributable to such items of gross income shall not be taken into account for purposes of section 952. See paragraph (d) of § 1.953-4 and section 11(e)(2).

(2) *Taxable years beginning after December 31, 1966.* Notwithstanding paragraph (a) of this section, a controlled foreign corporation's subpart F income for any taxable year beginning after December 31, 1966, shall not include any item of income from sources within the United States which is effectively connected for that year with the conduct by such corporation of a trade or business in the United States unless, pursuant to a treaty to which the United States is a party, such item of income either is exempt from the income tax imposed by chapter 1 (relating to normal taxes and surtaxes) of the Code or is subject to such tax at a reduced rate.

Thus, for example, dividends received from sources within the United States by a foreign corporation engaged in business in the United States during the taxable year, which are not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, shall not be excluded from subpart F income under section 952(b) and this subparagraph even though such dividends are subject to the tax of 30 percent imposed by section 881 (a). Also, for example, if, by reason of an income tax convention to which the United States is a party, an amount of interest from sources within the United States which is effectively connected for the taxable year with the conduct of a business in the United States by a foreign corporation is subject to tax under chapter 1 at a flat rate of 15 percent, as provided in § 1.871-12, such interest is not excluded from subpart F income under section 952(b) and this subparagraph. The deductions attributable to items of income which are excluded from subpart F income under this subparagraph shall not be taken into account for purposes of section 952.

(3) *Rule applicable under section 956 (b)(2).* For purposes only of paragraph (b)(1))(viii) of § 1.956-2, an item of income derived by a controlled foreign corporation from sources within the United States with respect to which for the taxable year a tax is imposed in accordance with section 882(a) shall be considered described in section 952(b) whether or not such item of income would have constituted subpart F income for such year.

(c) *Limitation on a controlled foreign corporation's subpart F income*—(1) *In general.* A United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of § 1.951-1) of a controlled foreign corporation's subpart F income for any taxable year shall not exceed his pro rata share of the earnings and profits (as defined in section 964(a) and § 1.964-1) of such corporation for such taxable year, computed as of the close of such taxable year without diminution by reason of any distributions made during such taxable year, minus the sum of—

(i) The amount, if any, by which such shareholder's pro rata share of—

(*a*) The sum of such corporation's deficits in earnings and profits for prior taxable years beginning after December 31, 1962, plus

(*b*) The sum of such corporation's deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963 (reduced by the sum of the earnings and profits (as so defined) of such corporation for any of such taxable years) exceeds

(*c*) The sum of such corporation's earnings and profits for prior taxable years beginning after December 31, 1962, which, with respect to such shareholder, are allocated to other earnings and profits under section 959(c)(3) and § 1.959-3; and

(ii) Such shareholder's pro rata share of any deficits in earnings and profits of other foreign corporations for a taxable year beginning after December 31, 1962, which are attributable to stock of such other foreign corporations owned by such shareholder within the meaning of section 958(a) and which, in accordance with section 952(d) and paragraph (d) of this section, are taken into account as a reduction in the controlled foreign corporation's earnings and profits for such taxable year.

For purposes of applying this subparagraph, the reduction (if any) provided by subdivision (i) of this subparagraph in a United States shareholder's pro rata share of the earnings and profits of a controlled foreign corporation shall be taken into account before the reduction provided by subdivision (ii) of this subparagraph. See section 952(c).

(2) *Special rules.* For purposes only of determining the limitation under subparagraph (1) of this paragraph on a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income for any taxable year—

(i) *Status of foreign corporation.* The earnings and profits, or deficit in earnings and profits, of a foreign corporation for any taxable year shall be taken into account whether or not such foreign corporation is a controlled foreign corporation at the time such earnings and profits are derived or such deficit in earnings and profits is incurred.

(ii) *Deficits in earnings and profits taken into account only once.* A controlled foreign corporation's deficit in earnings and profits for any taxable year preceding the taxable year shall be taken into account for the taxable year only to the extent such deficit has not been taken into account under this paragraph, paragraph (d) of this section, or paragraph (d)(2)(ii) of § 1.963-2 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) in computing a minimum distribution, for any taxable year preceding the taxable year, to reduce earnings and profits of such preceding year of such controlled foreign corporation or of any other controlled foreign corporation.

(iii) *Determination of pro rata share.* A United States shareholder's pro rata share of a controlled foreign corporation's earnings and profits, or deficit in earnings and profits, for any taxable year shall be determined in accordance with the principles of paragraph (e) of § 1.951-1 and paragraph (d)(2)(ii) of § 1.963-2.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). (a) A is a United States shareholder who owns 100 percent of the only class of stock of M Corporation, a controlled foreign corporation organized on January 1, 1963. Both A and M Corporation use the calandar year as a taxable year.

(b) During 1963, M Corporation derives $20,000 of subpart F income and has earnings and profits of $30,000. Corporation M makes no distributions to A during such year. The limitation under section 952(c) on M Corporation's subpart F income for 1963 is $30,000; and $20,000 is includible in A's gross income for such year under section 951(a)(1)(A)(i).

(c) On January 1, 1964, M Corporation acquires 100 percent of the only class of stock of N Corporation, a controlled foreign corporation which uses the calendar year as a taxable year. During 1964, N Corporation derives $6,000 of subpart F income, has $7,000 of earnings and profits, and distributes $5,000 to M Corporation. The limitation under section 952(c) on N Corporation's subpart F income for 1964 is $7,000; and $6,000 of subpart F income is includible in A's gross income for such year under section 951(a)(1)(A)(i).

(d) During 1964, M Corporation derives $8,000 of rents which constitute subpart F income, makes a $10,000 distribution to A, and has earnings and profits of $12,000 (including the $5,000 dividend received from N Corporation). The limitation under section 952(c) on M Corporation's subpart F income for 1964 is $7,000, determined as follows:

Corporation M's earnings and profits for 1964 (determined under section 964(a) and § 1.964-1 as of the close of such year without diminution for any distributions made during such year)	$12,000
Less: Corporation M's earnings and profits for 1964 described in section 959(b)	5,000
Limitation on M Corporation's subpart F income for 1964	7,000

Thus, for 1964 with respect to A's interest in M Corporation, $7,000 of subpart F income is includible in his gross income under section 951(a)(1)(A)(i). The $10,000 dividend received from M Corporation is excludible from A's gross income for 1964 under section 959(a)(1) and paragraph (b) of § 1.959-1.

Example (2). A is a United States shareholder who owns 100 percent of the only class of stock of R Corporation which was organized on January 1, 1961. R Corporation is a controlled foreign corporation for the entire period after December 31, 1962, here involved. Both A and R Corporation use the calendar year as a taxable year. During 1963, R Corporation derives $25,000 of subpart F income and has $50,000 of earnings and profits. Corporation R has $15,000 of earnings and profits for 1961, and a deficit in earnings and profits of $45,000 for 1962. Thus, R Corporation has as of December 31, 1963, a net deficit in earnings and profits of $30,000 for the years 1961 and 1962. Corporation R makes no distributions to A during 1963. The limitation under section 952(c) on R Corporation's subpart F income for 1963 is $20,000 ($50,000 minus $30,000), and $20,000 of subpart F income is includible in A's gross income for 1963 under section 951(a)(1)(A)(i). During 1964, R Corporation derives $18,000 of subpart F income and has $30,000 of earnings and profits. Corporation R makes no distributions to A during 1964. The entire $18,000 of subpart F income is includible in A's gross income for 1964 under section 951(a)(1)(A)(i).

(d) *Treatment of deficits in earnings and profits attributable to stock of other foreign corporation indirectly owned by a United States shareholder*—(1) *In general.* For purposes of paragraph (c)(1)(ii) of this section, if—

(i) A United States shareholder owns (within the meaning of section 958(a)) stock in two or more foreign corporations in a chain of foreign corporations (as defined in subparagraph (2)(ii) of this paragraph), and

(ii) Any of the corporations in such chain has a deficit in earnings and profits for a taxable year beginning after December 31, 1962, then, with respect to such shareholder and only for purposes of determining the limitation on subpart F income under paragraph (c) of this section, the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, in accordance with the rules of subparagraph (2) of this paragraph, be reduced to take into account any deficit in earnings and profits referred to in subdivision (ii) of this subparagraph. See section 952(d).

(2) *Special rules.* For purposes of this paragraph—

(i) *Applicable rules.* The special rules set forth in paragraph (c)(2) of this section shall apply.

(ii) *"Chain" defined.* A chain of foreign corporations shall, with respect to a United States shareholder, include—

(*a*) Any foreign corporation in which such shareholder owns (within the meaning of section 958(a)(1)(A)) stock but, only to the extent of the stock so owned and

(*b*) All foreign corporations in which such shareholder owns (within the meaning of section 958(a)(2)) stock, but only to the extent of the stock so owned by reason of his ownership of the stock referred to in (*a*) of this subdivision.

(iii) *Allocation of deficit.* If one or more foreign corporations (whether or not a controlled foreign corporation) includible in a chain of foreign corporations has a deficit in earnings and profits (determined under section 964(a) and § 1.964-1) for the taxable year, the amount of deficit taken into account under section 952(d) with respect to a United States shareholder in such chain as a reduction in earnings and profits for the taxable year of a controlled foreign corporation includible in such chain shall be an amount which bears the same ratio to such shareholder's pro rata share of the total deficit in earnings and profits for the taxable year of all includible foreign corporations as his pro rata share of the earnings and profits (determined under paragraph (c) of this section but without regard to the provisions of subparagraph (1)(ii) of such paragraph) for the taxable year of such includible controlled foreign corporation bears to his pro rata share of the total earnings and profits (as so determined under paragraph (c) of this section) for the taxable year of all includible controlled foreign corporations. The amount of deficit taken into account under this subdivision with respect to any controlled foreign corporation includible in a chain of foreign corporations shall not exceed the United States shareholder's pro rata share of the controlled foreign corporation's earnings and profits for the taxable year.

(iv) *Taxable year.* The taxable year from which a deficit is allocated under this paragraph, and the taxable year to which such deficit is allocated to reduce earnings and profits, shall be the taxable year of the foreign corporation ending with or within the taxable year of the United States shareholder described in subparagraph (1)(i) of this paragraph.

(3) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example (1). (a) Domestic corporation M owns 100 percent, 20 percent, and 100 percent, respectively, of the only class of stock of foreign corporations A, B, and F, respectively. Corporation A owns 80 percent of the only class of stock of each of foreign corporations B and C, respectively. Corporation F owns 20 percent of such stock of C Corporation. Corporation B owns 75 percent of the only class of stock of foreign corporation D, and 50 percent of the only class of stock of each of foreign corporations G and H, respectively. C Corporation owns 75 percent of the only class of stock of foreign corporation E. All the corporations use the calendar year as a taxable year, and all of the foreign corporations, except corporations G and H, are controlled foreign corporations throughout the period here involved.

(b) The subpart F income, and the earnings and profits (determined under paragraph (c) of this section but without regard to subparagraph (1)(ii) of such paragraph) or deficit in earnings and profits (determined under section 964(a) and § 1.964-1), of each of the foreign corporations for 1963 are as follows, the deficits being set forth in parenthesis:

	Subpart F income	Earnings and profits (deficits)
A Corporation	$6,000	$18,000
B Corporation		(7,500)
C Corporation		(2,500)

	Subpart F income	Earnings and profits (deficits)
D Corporation	4,000	5,000
E Corporation	12,000	15,000
F Corporation	8,000	20,250
G Corporation		(10,000)
H Corporation		7,000

(c) The chains of foreign corporations (within the meaning of subparagraph (2)(ii) of this paragraph) for 1963 are the "A" chain, consisting of corporations, A, B, C, D, E, G, and H, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in A Corporation; the "B" chain, consisting of corporations B, D, G, and H, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in B Corporation; and the "F" chain, consisting of corporations F, C, and E, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in F Corporation.

(d) Corporation M's stock interest under section 958(a) in each of the chains of foreign corporations is as follows for 1963:

[In percent]

	A	B	C	D	E	F	G	H
A chain:								
Direct interest	100							
(100% × 80%)		80						
(100% × 80%)			80					
(80% × 75%)				60				
(80% × 75%)					60			
(80% × 50%)							40	
(80% × 50%)								40
B chain:								
Direct interest		20						
(20% × 75%)				15				
(20% × 50%)							10	
(20% × 50%)								10
F chain:								
Direct interest						100		
(100% × 20%)			20					
(20% × 75%)					15			
Total interests	100	100	100	75	75	100	50	50

(e) Corporation M's pro rata share of the earnings and profits (determined under paragraph (c) of this section but without regard to subparagraph (1)(ii) of such paragraph), or of the deficit, of each controlled foreign corporation of each foreign corporation, respectively, includible in the respective chains for 1963 is as follows:

	Earnings and profits	Deficit
A chain:		
A Corporation (100%)	$18,000	
B Corporation (80%)		($6,000)
C Corporation (80%)		(2,000)
D Corporation (60%)	3,000	
E Corporation (60%)	9,000	
G Corporation (40%)		(4,000)
H Corporation (40%)	(1)	
Total	30,000	(12,000)
B chain:		
B Corporation (20%)		($1,500)
D Corporation (15%)	$750	
G Corporation (10%)		(1,000)
H Corporation (10%)	(1)	
Total	$750	($2,500)
F chain:		
F Corporation (100%)	20,250	
C Corporation (20%)		(500)
E Corporation (15%)	2,250	
Total	$22,500	(500)

[1] The earnings and profits of H Corporation are not included in the total earnings and profits for the chain because H Corporation is not a controlled foreign corporation.

(f) The amount by which M Corporation's pro rata share of the earnings and profits for 1963 of the controlled foreign corporations in each respective chain shall be reduced under section 952(d) by M Corporation's pro rata share of the deficits of corporations B, C, and G for 1963 is determined as follows:

		Amount of reduction
A chain:		
A Corporation ($12,000 × $18,000/$30,000)		$7,200
D Corporation ($12,000 × $3,000/$30,000)		1,200
E Corporation ($12,000 × $9,000/$30,000)		3,600
Total		12,000
B chain:		
D Corporation ($2,500 × $750/$750)	$2,500	
Limitation: M Corporation's pro-rata share of D Corporation's earnings and profits	750	
Allocation of used deficit ($750) to M Corporation's pro rata share of the deficits of corporations B and G:		
B Corporation ($750 × ($1,500/$2,500))	$450	
G Corporation ($750 × ($1,000/$2,500))	300	
Total	750	$750
F chain:		
F Corporation ($500 × $20,250/$22,500)		450
E Corporation ($500 × $2,250/$22,500)		50
Total		500

(g) Corporation M's pro rata share of the earnings and profits (determined after reduction for deficits under section 952(d)) for 1963 of each controlled foreign corporation in the respective chains, determined on a chain-by-chain basis, is determined as follows:

	Earnings and profits before reduction	Reduction (sec. 952(d))	Reduced earnings and profits
A chain:			
A Corporation	$18,000	$7,200	$10,800
D Corporation	3,000	1,200	1,800
E Corporation	9,000	3,600	5,400
B chain: D Corporation	750	750	
F chain:			
F Corporation	20,250	450	19,800
E Corporation	2,250	50	2,200

(h) Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1963 which is includible in its gross income for such year under section 951(a)(1)(A)(i) and § 1.951-1 is determined as follows:

	Subpart F income (before limitation)	Earnings and profit (sec. 952 (c))	Amount includible in income
A Corporation (100%)	$6,000	$10,800	$6,000
D Corporation (75%)	3,000	1,800	1,800
E Corporation (75%)	9,000	7,600	7,600
F Corporation (100%)	8,000	19,800	8,000
Total includible under sec. 951(a)(1)(A)(i)			23,400

Example (*2*). The facts are the same as in example (1) except that, in addition, for 1964, foreign corporations C, D, and E have no subpart F income and no earnings and profits and foreign corporations G and H have no earnings and profits. For 1964, B Corporation has subpart F income of $1,000 and earnings and profits (determined in accordance with section 964(a) and § 1.964-1) of $1,500; A Corporation has subpart F income of $800 and earnings and profits of $1,000; and F Corporation has subpart F income of $500 and earnings and profits of $1,000. Such earnings and profits are determined without regard to distributions for 1964. Corporation B has an unused deficit in earnings and profits of $1,050 for 1963 ($1,500 minus $450) applicable to M Corporation's interest in such corporation (paragraph (f) of example (1)), and, under paragraph (c)(1)(i)(*a*) of this section, with respect to M Corporation, such deficit reduces B Corporation's earnings and profits for 1964 to $450. Inasmuch as G Corporation is not a controlled foreign corporation for 1964, such corporation's unused deficit in earnings and profits of $700 for 1963 ($1,000 minus $300) applicable to M Corporation's interest in such corporation (paragraph (f) of example (1)) may be used under paragraph (c)(1)(i)(*a*) of this section to reduce M Corporation's interest in G Corporation's earnings and profits in a later year or years for which G Corporation is a controlled foreign corporation. Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1964 which is includible in its gross income for such year under section 951(a)(1)(A)(i) and § 1.951-1 is determined as follows:

	Subpart F income (before limitation)	Earnings and profits (sec. 952(c))	Amount includible in income
A Corporation	$800	$1,000	$800
B Corporation	1,000	450	450
F Corporation	500	1,000	500

Example (3). The facts are the same as in example (2), except that for 1964 B Corporation has subpart F income of $550 and earnings and profits (determined in accordance with section 964(a) and § 1.964-1) of $550; such earnings and profits are determined without regard to distributions for 1964. Under paragraph (c)(1)(i)(a) of this section, B Corporation's unused deficit of $1,050 for 1963 reduces its earnings and profits for 1964 with respect to M Corporation to zero. The remaining $500 of the unused deficit for 1963 applicable to M Corporation's interest in B Corporation may be used under paragraph (c)(1)(i)(*a*) of this section in later years to reduce M Corporation's interest in B Corporation's earnings and profits.

[T.D. 6795, 30 FR 938, Jan. 29, 1965, as amended by T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7545, 43 FR 19652, May 8, 1978]

§ 1.952-2 Determination of gross income and taxable income of a foreign corporation.

(a) *Determination of gross income*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the gross income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 61 and the regulations thereunder.

(2) *Insurance gross income*—(i) *Life insurance gross income.* The gross income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of chapter 1 of the Code applies, shall, subject to the special rules of paragraph (c) of this section, be the sum of—

(*a*) The gross investment income, as defined under section 804(b), except that interest which is excluded from gross income under section 103 shall not be taken into account;

(*b*) The sum of the items taken into account under section 809(c), except that advance premiums shall not be taken into account; and

(*c*) The amount by which the net long-term capital gain exceeds the net short-term capital loss.

(ii) *Mutual and other insurance gross income.* The gross income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a mutual insurance company to which part II (sections 821 through 826) of subchapter L of chapter 1 of the Code applies or as a mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of chapter 1 of the Code applies, shall, subject to the special rules of paragraph (c) of this section, be—

(*a*) The sum of—

(*1*) The gross income, as defined in section 832(b)(1);

(*2*) The amount of losses incurred, as defined in section 832(b)(5); and

(*3*) The amount of expenses incurred, as defined in section 832(b)(6); reduced by

(*b*) The amount of interest which under section 103 is excluded from gross income.

(b) *Determination of taxable income*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the taxable income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 63.

(2) *Insurance taxable income.* The taxable income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as an insurance company to which subchapter L of chapter 1 of the Code applies shall, subject to the special rules of paragraph (c) of this section, be determined by treating such corporation as a domestic corporation taxable

under subchapter L of chapter 1 of the Code and by applying the principles of §§ 1.953-4 and 1.953-5 for determining taxable income.

(c) *Special rules for purposes of this section*—(1) *Nonapplication of certain provisions.* Except where otherwise distinctly expressed, the provisions of subchapters F, G, H, L, M, N, S, and T of chapter 1 of the Code shall not apply.

(2) *Application of principles of § 1.964-1.* The determinations with respect to a foreign corporation shall be made as follows:

(i) *Books of account.* The books of account to be used shall be those regularly maintained by the corporation for the purpose of accounting to its shareholders.

(ii) *Accounting principles.* Except as provided in subparagraphs (3) and (4) of this paragraph, the accounting principles to be employed are those described in paragraph (b) of § 1.964-1. Thus, in applying accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of foreign affiliates, no adjustment need be made unless such adjustment will have a material effect, within the meaning of paragraph (a) of § 1.964-1.

(iii) *Translation into United States dollars*—(*a*) *In general.* Except as provided in (*b*) of this subdivision, the amounts determined in accordance with subdivision (ii) of this subparagraph shall be translated into United States dollars in accordance with the principles of paragraph (d) of § 1.964-1.

(*b*) *Special rule.* In any case in which the value of the foreign currency in relation to the United States dollar fluctuates more than 10 percent during any translation period (within the meaning of paragraph (d)(6) of § 1.964-1), the subpart F income and non-subpart F income shall be separately translated as if each constituted all the income of the controlled foreign corporation for the translation period.

(iv) *Tax accounting methods.* The tax accounting methods to be employed are those established or adopted by or on behalf of the foreign corporation under paragraph (c) of § 1.964-1. Thus, such accounting methods must be consistent with the manner of treating inventories, depreciation, and elections referred to in subdivisions (ii), (iii), and (iv) of paragraph (c)(1) of § 1.964-1 and used for purposes of such paragraph; however, if, in accordance with paragraph (c)(6) of § 1.964-1, a foreign corporation receives foreign base company income before any elections are made or before an accounting method is adopted by or on behalf of such corporation under paragraph (c)(3) of § 1.964-1, the determinations of whether an exclusion set forth in section 954(b) applies shall be made as if no elections had been made and no accounting method had been adopted.

(v) *Exchange gain or loss.* Exchange gain or loss, determined in accordance with the principles of paragraph (e) of § 1.964-1, shall be taken into account and shall be allocated between subpart F income and non-subpart F income for any taxable year under a method which is reasonable under all the facts and circumstances. For example, such exchange gain or loss may be allocated to subpart F income in the same ratio that gross subpart F income of the corporation for the taxable year bears to its total gross income for the taxable year, determined without regard to this subdivision.

(3) *Necessity for recognition of gain or loss.* Gross income of a foreign corporation (including an insurance company) includes gain or loss only if such gain or loss would be recognized under the provisions of the Internal Revenue Code if the foreign corporation were a domestic corporation taxable under section 11 (subject to the modifications of subparagraph (1) of this paragraph). See section 1002. However, a foreign corporation shall not be treated as a domestic corporation for purposes of determining whether section 367 applies.

(4) *Gross income and gross receipts.* The term "gross income" may not have the same meaning as the term "gross receipts". For example, in a manufacturing, merchandising, or mining business, gross income means the total sales less the cost of goods sold, plus any income from invest-

ments and from incidental or outside operations or sources.

(5) *Treatment of capital loss and net operating loss.* In determining taxable income of a foreign corporation for any taxable year—

(i) *Capital loss carryover.* The capital loss carryover provided by section 1212(a) shall not be allowed.

(ii) *Net operating loss deduction.* The net operating loss deduction under section 172(a) or the operations loss deduction under section 812 shall not be allowed.

(6) *Corporations which have insurance income.* For purposes of paragraphs (a)(2) and (b)(2) of this section, in determining whether a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as an insurance company to which subchapter L of chapter 1 of the Code applies, it is immaterial that—

(i) The corporation would be exempt from taxation as an organization described in section 501(a),

(ii) The corporation would not be taxable as an insurance company to which subchapter L of the Code applies, or

(iii) The corporation would be subject to the alternative tax for small mutual insurance companies provided by section 821(c).

[T.D. 6795, 30 FR 941, Jan. 29, 1965]

§ 1.953-1 Income from insurance of United States risks.

(a) *In general.* The subpart F income of a controlled foreign corporation for any taxable year includes its income derived from the insurance of United States risks for such taxable year. See section 952(a)(1). A controlled foreign corporation shall have income derived from the insurance of United States risks for such purpose of it has taxable income, as determined under § 1.953-4 or § 1.953-5, which is attributable to the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks, as defined in § 1.953-2 or § 1.953-3, and if it satisfies the 5-percent minimum premium requirement prescribed in paragraph (b) of this section. It is immaterial for purposes of this section whether the person insured or the beneficiary of any insurance, annuity, or reinsurance contract is, as to such corporation, a related person or a United States shareholder. For definition of the term "controlled foreign corporation" for purposes of taking into account income derived from the insurance of United States risks under section 953, see section 957 (a) and (b) and §§ 1.957-1 and 1.957-2.

(b) *5-percent minimum premium requirement.* A controlled foreign corporation shall not have income derived from the insurance of United States risks for purposes of this section unless the premiums received by such corporation during the taxable year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with the United States risks exceed 5 percent of the total premiums which are received by such corporation during such taxable year and which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with all risks.

(c) *General definitions.* For purposes of §§ 1.953-1 to 1.953-6, inclusive—

(1) *Reinsurance, etc.* The terms "reinsurance", "insurance", and "annuity contract" have the same meaning which they have for purposes of applying section 809(c)(1) or section 832(b)(4), as the case may be.

(2) *Premiums.* The term "premiums" means the items taken into account for the taxable year under section 809(c)(1), or the amount computed for the taxable year under section 832(b)(4) without the application of subparagraph (B) thereof, as the case may be; except that, for purposes of determining the amount of premiums received in applying paragraph (b) of this section or paragraph (a) of § 1.953-3, advance premiums and deposits shall not be taken into account.

(3) *Insurance company.* The term "insurance company" has the same meaning which it has for purposes of applying section 801(a), determined by applying the principles of paragraph (a) of § 1.801-3.

(4) *Related person.* The term "related person", when used with respect to

a controlled foreign corporation, shall have the meaning assigned to it by paragraph (e) of § 1.954-1.

(5) *Policy period.* With respect to any insurance or annuity contract under which a corporation is potentially liable at any time during its taxable year, the term "policy period" means with respect to such year each period of coverage under the contract if such period begins or ends with or within the taxable year, except that, if such period of coverage is more than one year, such term means such of the following periods as are applicable, each one of which is a policy period with respect to the taxable year:

(i) The one-year period which begins with the effective date of the contract and begins or ends with or within the taxable year,

(ii) The one-year period which begins with an anniversary of the contract and begins or ends with or within the taxable year, and

(iii) The period of less than one year if such period begins with an anniversary of the contract, ends with the date on which coverage under the contract terminates, and begins or ends with or within the taxable year.

For such purposes, the effective date of the contract is the date on which coverage under the contract begins, and the anniversary of the contract is the annual return of the effective date. The period of coverage under a contract is the period beginning with the effective date of the contract and ending with the date on which the coverage under the contract expires; except that, if the risk under the contract has been transferred by assumption reinsurance, the period of coverage shall end with the effective date of such transfer or, if the contract is canceled, with the effective date of cancellation. For this purpose, the term "assumption reinsurance" shall have the meaning provided by paragraph (a)(7)(ii) of § 1.809-5. The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A issues to domestic corporation M an insurance contract which provides coverage for the 2½ year period beginning on July 1, 1963. Corporation A uses the calendar year as the taxable year. For 1963, the policy period under such contract as to A Corporation is July 1, 1963, to June 30, 1964. For 1964, the policy periods under such contract as to A Corporation are July 1, 1963, to June 30, 1964, and July 1, 1964, to June 30, 1965. For 1965, the policy periods under such contract as to A Corporation are July 1, 1964, to June 30, 1965, and July 1, 1965, to December 31, 1965.

Example (2). The facts are the same as in example (1) except that M Corporation cancels the contract on August 31, 1963. For 1963, the policy period under such contract as to A Corporation is July 1, 1963, to August 31, 1963.

Example (3). The facts are the same as in example (1) except that on January 15, 1965, A Corporation cedes insurance under the contract to controlled foreign corporation B, which also uses the calendar year as the taxable year. For 1964, the policy periods under such contract as to A Corporation are July 1, 1963, to June 30, 1964, and July 1, 1964, to June 30, 1965. For 1965, the policy periods under such contract as to both A Corporation and B Corporation are July 1, 1964, to June 30, 1965, and July 1, 1965, to December 31, 1965.

Example (4). Controlled foreign corporation C, which uses the calendar year as the taxable year, issues to domestic corporation N an insurance contract which covers the marine risks in connection with shipping a machine to Europe. The contract does not specify the dates during which the machine is covered, but provides coverage from the time the machine is delivered alongside a named vessel in Hoboken, New Jersey, until the machine is delivered alongside such vessel in Liverpool, England. Such deliveries in New Jersey and England take place on February 1, and February 28, 1963, respectively. For 1963, the policy period under such contract as to C Corporation is February 1, to February 28, 1963.

(6) *Foreign country.* The term "foreign country" includes, where not otherwise expressly provided, a possession of the United States.

[T.D. 6781, 29 FR 18201, Dec. 23, 1964]

§ 1.953-2 Actual United States risks.

(a) *In general.* For purposes of paragraph (a) of § 1.953-1, the term "United States risks" means risks described in section 953(a)(1)(A)—

(1) In connection with property in the United States (as defined in paragraph (b) of this section),

(2) In connection with liability arising out of activity in the United States (as defined in paragraph (c) of this section), or

(3) In connection with the lives or health of residents of the United States (as defined in paragraph (d) of this section).

For purposes of section 953(a), the term "United States" is used in a geographical sense and includes only the States and the District of Columbia. Therefore, the reinsuring or the issuing of insurance or annuity contracts by a controlled foreign corporation in connection with property located in a foreign country or a possession of the United States, in connection with activity in a foreign country or a possession, or in connection with the lives or health of citizens of the United States who are not residents of the United States will not give rise to income to which paragraph (a) of § 1.953-1 applies, unless the income derived by the controlled foreign corporation from such contracts constitutes income derived in connection with risks which are deemed to be United States risks, as defined in § 1.953-3.

(b) *Property in the United States.* The term "property in the United States" means property, as defined in subparagraph (1) of this paragraph, which is in the United States, within the meaning of subparagraph (2) of this paragraph.

(1) *Property defined.* The term "property" means any interest of an insured in tangible (including real and personal) or intangible property. Such interests include, but are not limited to, those of an owner, landlord, tenant, mortgagor, mortgagee, trustee, beneficiary, or partner. Thus, for example, if insurance is issued against loss from fire and theft with respect to an insured's home and its contents, such risks are risks in connection with property, whether the insured is the owner or lessee and whether the contents include furniture or cash and securities. Furthermore, if insurance is issued against all risks of damage or loss with respect to the automobile of an insured, such risks are risks in connection with property, whether the risks insured against may be caused by the insured, another person, or natural forces.

(2) *United States location*—(i) *In general.* Property will be considered property in the United States when it is exclusively located in the United States. Conversely, property will be considered property not in the United States when it is exclusively located outside the United States. In addition, property which is ordinarily located in, but temporarily located outside, the United States will be considered property in the United States both when it is ordinarily located in, and when it is temporarily located outside, the United States if the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such property cannot be allocated to, or apportioned between, risks incurred when such property is actually located in the United States and risks incurred when it is actually located outside the United States. If such premium can be so allocated or apportioned on a reasonable basis, however, such property will be considered property not in the United States when it is actually located outside the United States. However, property will not be considered property in the United States if it is neither property which is exclusively located in the United States nor property which is ordinarily located in, but temporarily located outside, the United States. The rules prescribed in subdivision (ii) of this subparagraph shall apply in determining whether a premium can be allocated or apportioned on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States. The rules prescribed in subdivisions (iii) through (x) of this subparagraph shall apply in determining whether property is, or will be considered, exclusively located in or outside the United States and whether property is, or will be considered, ordinarily located in the United States; such rules also limit the rule of premium allocation and apportionment prescribed in this subdivision and subdivision (ii) of this subparagraph. The determinations required by this subparagraph shall be made with respect to the location of property during the policy period applicable to the taxable year of the insuring or reinsuring corporation, or, if more than one policy period exists with re-

spect to such taxable year, such determinations shall be made separately with respect to the location of property during each such policy period.

(ii) *Premium allocation or apportionment.* Whether a premium can be allocated or apportioned on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States shall depend on the intention of the parties to the insurance contract, as determined from its provisions and the facts and circumstances preceding its execution. Contract provisions on the basis of which the premium reasonably may be so allocated or apportioned include, but are not limited to, provisions which separately describe each risk covered, the period of coverage of each risk, the special warranties for each risk, the premium for each risk (or the basis for determining such premium), and the conditions of paying the premium for each risk. For purposes of this subdivision, it shall be unnecessary formally to make a separate policy with respect to each risk covered or with respect to each clause attached to the policy, provided that the intention of the parties to the contract is reasonably clear. For example, if in the ordinary course of carrying on an insurance business an insurance policy is issued which covers fire, theft, and water damage risks incurred when property is actually located in the United States and marine risks incurred when such property is actually located outside the United States and which, pursuant to accepted insurance principles, properly describes the premium rates as percentages of the amount of coverage as ".825% plus .3% fire, etc. risks plus .12% water risks = 1.245%", a reasonable basis exists to allocate a $124.50 premium paid for $10,000 of such coverage to $82.50 for foreign risks and $42.00 ($30.00+ $12.00) to United States risks.

(iii) *Property in general*—(*a*) *Ordinary and temporary location.* Except as otherwise provided in subdivisions (iv) through (x) of this subparagraph, the determination of whether property is ordinarily located in the United States will depend on all the facts and circumstances in each case. Property is ordinarily located in the United States if its location in the United States is regular, usual, or often occurring. However, in all cases property will be considered ordinarily located in the United States if it is actually located in the United States for an aggregate of more than 50 percent of the days in the applicable policy period whereas property will, under no circumstances, be considered ordinarily located in the United States if it is actually located in the United States for an aggregate of not more than 30 percent of the days in the applicable policy period. Property which is ordinarily located in the United States is temporarily located outside the United States when it is actually located outside the United States. For purposes of determining the number and percent of the days in an applicable policy period, the term "day" means, not any 24-consecutive-hour period, but a continuous period of twenty-four hours commencing from midnight and ending with the following midnight; in determining the location of property for such purposes, an amount of time which is at least one-half of such a day, but less than the entire day, shall be considered a day, and an amount of time which is less than one-half of such a day shall not be considered a day.

(*b*) *Illustrations.* The application of this subdivision may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation A issues to domestic corporation M a comprehensive blanket or floater insurance policy which, for one year, covers inventory samples which M Corporation regularly ships from the United States in order to encourage sales. Such shipments are made on the condition that they be returned to the United States within 5 days after they are received. During the one-year policy period, such samples are sent from, and returned to, the United States 50 times, and during such one-year period are actually located in the United States for an aggregate of 120 days. Since the location of the samples in the United States during such one-year period is often recurring, they are property ordinarily located in, but temporarily located outside, the United States. Therefore, they will be considered property in the United States even though for such one-year period their location in the United States is not regular or usual and is not for an aggregate of more than 50 percent of the days in the policy period. However, if, by considering such factors as the terms and premium schedule of the insurance contract as well as the number, value, and duration of the location in and outside the United States, of such samples, the premium which is attributable to the issuing of such contract can be allocated to, or apportioned between, risks occurring when such samples are actually located in the United States and risks occurring when they are actually located outside the United States, such samples will be considered property not in the United States when they are actually located outside the United States.

Example (2). A machine, located for several years in a foreign branch of a United States manufacturer, is permanently transferred to the home office of such manufacturer, where it arrives on January 1, 1963, and remains for the remainder of 1963. Under a separate insurance contract issued by a controlled foreign corporation, which uses the calendar year as the taxable year, such machine is insured against damage for the three-year period commencing on May 1, 1962. Because of the change in location of the machine, the premiums are increased as of January 1, 1963. Since the machine is in the United States from January 1, 1963, to April 30, 1963, its location in the United States is regular and usual during the policy period of May 1, 1962, to April 30, 1963. Accordingly, the machine is ordinarily located in the United States for such policy period. However, since the premium which is attributable to the issuing of such contract is allocable to risks occurring when the machine is actually located in, and when it is actually located outside, the United States, such machine will be considered property not in the United States from May 1, 1962, through December 31, 1962.

(iv) *Commercial motor vehicles, ships, aircraft, railroad rolling stock, and containers.* Any motor vehicle, ship, aircraft, railroad rolling stock, or any container transported thereby, which is used exclusively in the commercial transportation of persons or property to or from the United States (including such transportation from one place to another in the United States) and is ordinarily located in the United States will be considered property in the United States both when such property is ordinarily located in, and when such property is temporarily located outside, the United States. Whether such property is used in the transportation of persons or property to or from the United States and is ordinarily located in the United States are issues to be determined from all the facts and circumstances in each case. However, in all cases such transportation property will be considered ordinarily located in the United States if either more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States or such property is located in the United States more than 50 percent of the time during such period. Further, such transportation property will not at any time be considered property in the United States if either not more than 30 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States or such property is located in the United States for not more than 30 percent of the time during such period. Nevertheless, if not more than 30 percent of the miles traversed during the applicable policy period in the use of such transportation property are traversed within the United States, such property will be considered ordinarily located in the United States if it is located in the United States more than 50 percent of the time during such period Moreover, if such transportation property is located in the United States for not more than 30 percent of the time during the applicable policy period, such property will be considered ordinarily located in the United States if more than 50 percent of the miles traversed during such period in the use of such property are traversed within the United States. If such transportation property is considered property in the United States because more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States, the apportionment of premium provided in subdivision (i) of this subparagraph shall be made on a mileage basis. If, however, such property is considered property in the United States because such property is located in the United States more than 50 percent of the time during the applicable policy period, the apportionment of premium provided in subdivision (i) of this subparagraph shall be made on a time basis.

(v) *Noncommercial motor vehicles, ships, aircraft, and railroad rolling stock.* Except as provided in subdivision (iv) of this subparagraph, any motor vehicle, ship or boat, aircraft, or railroad rolling stock which at any time is actually located in the United States and which either (*a*) is registered with the United States, a State (including any political subdivision thereof), or any agency thereof or (*b*), if not so registered, is owned by a citizen, resident, or corporation of the United States will be considered property which is ordinarily located in the United States. Unless the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such property considered ordinarily located in the United States is specifically allocated under the contract to risks incurred when such property is actually located in the United States and to risks incurred when it is actually located outside the United States, such property will be considered property in the United States both when it is ordinarily located in, and when it is temporarily located outside, the United States; under no circumstances will such property be considered outside the United States on the basis of any apportionment of such premium.

(vi) *Property exported or imported by railroad or motor vehicle.* Any property which is exported from, or imported to, the United States by railroad or motor vehicle will be considered property ordinarily located in the United States which, when such property is not actually located in the United States, is temporarily located outside the United States. For example, if an insurance contract reinsured or issued in connection with property exported from the United States by motor vehicle covers risks commencing when such property is loaded on the motor vehicle at the United States warehouse and terminating when such property is unloaded at the foreign warehouse, and if the premium payable with respect to risks incurred when the property is in the United States and risks incurred when the property is in the foreign country is not separately stated, such property will be considered property in the United States only until such property is actually located outside the United States, provided that the premium can be properly apportioned (for example) on the basis of time or mileage, between risks incurred when the property is actually located in the United States and risks incurred when it is actually located outside the United States. If in such case the premium is not so apportionable, such property will be considered property in the United States both when such property is ordinarily located in, and when it is temporarily located outside, the United States.

(vii) *Property exported by ship or aircraft.* If an insurance contract which is reinsured or issued in connection with property which is exported from the United States by ship or aircraft covers risks all of which terminate when such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property in the United States. If such insurance contract covers risks all of which commence when such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property not in the United States. If such insurance contract covers risks commencing before, and terminating after, such property is placed aboard a ship or aircraft at the United States port of exit for shipment from the United States, such property will be considered property ordinarily located in the United States which, after such property is placed aboard such ship or aircraft at the United States port of exit, is temporarily located outside the United States. The application of this subdivision may be illustrated by the following example:

Example. A controlled foreign corporation issues an insurance contract in connection with property exported from the United States by ship. The contract covers risks commencing after such property is removed from the United States warehouse and terminating when such property is unloaded at the foreign port of entry. Assuming that the premium payable with respect to the risks incurred before and the risks incurred after the property is placed aboard the ship at the United States port of exit for shipment from the United States or with respect to the steps in handling such property during such coverage, such as transporting the property to the United States port of exit, unloading the property there, placing the property aboard the ship, holding the property aboard the ship in port, the actual voyage, and unloading the property at the foreign port of entry, is separately stated in, or is determinable from, such contract, the property will be considered property in the United States only until such property is placed aboard the ship at the United States port of exit for shipment from the United States. Assuming, however, that the premiums payable with respect to such steps, or with respect to the risks incurred before and the risks incurred after the property is placed aboard the ship at the United States port of exit, are not allocable or apportionable under the contract, such property will be considered property in the United States both before and after such property is placed aboard the ship at the United States port of exit.

(viii) *Property imported by ship or aircraft.* If an insurance contract which is reinsured or issued in connection with property which is imported to the United States by ship or aircraft covers risks all of which terminate when such property is unloaded at the United States port of entry, such property will be considered property not in the United States. If such insurance contract covers risks all of which commence after such property is unloaded at the United States port of entry, such property will be considered property in the United States. If such insurance contract covers risks commencing before, and terminating after, such property is unloaded at the United States port of entry, such property will be considered property ordinarily located in the United States which, before such property is unloaded at the United States port of entry, is temporarily located outside the United States. For an illustration pertaining to the allocation or apportionment of the premium, see the example in subdivision (vii) of this subparagraph.

(ix) *Shipments originating and terminating in the United States.* Any property which is shipped from one place in the United States to another place in the United States, on or over a foreign country, the high seas, or the coastal waters of the United States will be considered property actually located at all times in the United States. For example, property which is shipped from New York City to Los Angeles via the Panama Canal or from San Francisco to Hawaii or Alaska will be considered property actually located at all times in the United States.

(x) *Shipments originating and terminating in a foreign country.* Any property which is shipped by any means, or a combination of means, of transportation from one foreign country to another foreign country, or from a contiguous foreign country to the same contiguous foreign country, on or over the United States will be considered property exclusively located outside the United States. Notwithstanding the foregoing, any property which is shipped by any means, or a combination of means, of transportation from one contiguous foreign country to another contiguous foreign country on or over the United States will be considered property ordinarily located in the United States which, when such property is not actually located in the United States, is temporarily located outside the United States.

(c) *Liability from United States activity.* The term "liability arising out of activity in the United States" means a loss, as described in subparagraph (1) of this paragraph, or a liability, as described in subparagraph (2) of this paragraph, which could arise from activity performed in the United States, as defined in subparagraph (3) of this paragraph.

(1) *Loss described.* The term "loss" includes all loss of an insured which could arise from the occurrence of the event insured against except that such term does not include any loss in connection with property described in paragraph (b) of this section. For example, such term includes, in the case of a promoter of outdoor sporting events, the loss which could arise from the cancellation of such an event because of inclement weather.

(2) *Liability described.* The term "liability" includes all liability of an insured in tort, contract, property, or otherwise. It includes, for example, the liability of a principal for the acts

of his agent, of a husband for the acts of his spouse, and of a parent for the acts of his child. The term not only includes the direct liability which may be incurred, for example, by a tortfeasor to the person harmed, but also the indirect liability which may be incurred, for example, by a manufacturer to the purchaser at retail for a breach of warranty.

(3) *Activity in the United States*—(i) *In general.* A loss or liability will be considered a loss or liability which could arise from activity performed in the United States if the loss or liability would result, if at all, from an activity exclusively carried on in the United States. Conversely, a loss or liability will be considered a loss or liability which could not arise from activity performed in the United States if the loss or liability would result, if at all, from an activity exclusively carried on outside the United States. In addition, a loss or liability will be considered a loss or liability which could arise from activity performed in the United States if the loss or liability would result, if at all, from an activity ordinarily carried on in, but partly carried on outside, the United States. If the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with an activity ordinarily carried on in, but partly carried on outside, the United States can, on a reasonable basis, be allocated to, or apportioned between, the risks incurred with respect to the activity carried on in, and the risks incurred with respect to the activity carried on outside, the United States, such loss or liability will be considered a loss or liability which could not arise from activity performed in the United States to the extent the loss or liability would result, if at all, from that activity carried on outside the United States. However, a loss or liability will not be considered a loss or liability which could arise from an activity performed in the United States if such loss or liability would result, if at all, from an activity which is neither exclusively carried on in the United States nor ordinarily carried on in, but partly carried on outside, the United States. The principles of paragraph (b)(2)(ii) of this section for allocating or apportioning a premium on a reasonable basis to or between risks incurred when property is actually located in the United States and risks incurred when such property is actually located outside the United States shall apply for allocating or apportioning a premium on a reasonable basis to or between the risks incurred with respect to the activity carried on in, and the risks incurred with respect to the activity carried on outside, the United States. The rules prescribed in subdivisions (ii) through (vi) of this subparagraph shall apply in determining whether an activity is, or will be considered, exclusively carried on in or outside the United States and whether an activity is, or will be considered, ordinarily carried on in the United States and in determining what is the activity which is performed by the insured from which a loss or liability results or could result; such rules also limit the rule of premium allocation and apportionment prescribed in this subdivision. The determinations required by this subparagraph shall be made with respect to the location of an activity of the insured performed during the policy period applicable to the taxable year of the insuring or reinsuring corporation, or, if more than one policy period exists with respect to such taxable year, such determinations shall be made separately with respect to the location of the activity during each such policy period.

(ii) *Substantial activity carried on in the United States.* The term "activity" is used in its broadest sense and includes the performance of an act unlawfully undertaken, the wrongful performance of an act lawfully undertaken, and the wrongful failure to perform an act lawfully required to be undertaken. With respect to a loss described in subparagraph (1) of this paragraph, the term "activity" includes the occurrence of the event insured against. The determination of whether an activity ordinarily is carried on in, but is partly carried on outside, the United States will depend on all the facts and circumstances in each case. An activity ordinarily is carried on in the United States if a substantial amount of such activity is carried on in the United States. Factors which will be taken into account in determining whether a substantial amount of activity is carried on in the United States are those which are connected with the activity and include, but are not limited to, the location of the insured's assets, the place where personal services are performed, and the place where sales occur, but only if such assets, services, and sales are connected with the activity. In all cases an activity will be considered substantially carried on in the United States if more than 50 percent of the insured's total assets, personal services, and sales, if any, connected with such activity are located, performed, or occur in the United States. On the other hand, an activity will, under no circumstances, be considered substantially carried on in the United States if not more than 30 percent of the insured's total assets, personal services, and sales, if any, connected with such activity are located, performed, or occur in the United States. For this purpose, the mean of the value of the total assets at the beginning and end of the policy period shall be used, determined by taking assets into account at their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be (*a*) face value in the case of bills receivable, accounts receivable, notes receivable, and open accounts held by an insured using the cash receipts and disbursements method of accounting and (*b*) adjusted basis in the case of all other assets. Personal services shall be measured by the amount of compensation paid or accrued for such services, and sales shall be measured by the volume of gross sales. An activity is carried on partly outside the United States if it is carried on, whether substantially or insubstantially, outside the United States.

(iii) *Manufacturing, producing, constructing, or assembling activity.* If a person who manufactures, produces, constructs, or assembles property is liable with regard to the consumption or use of such property, such liability will be considered to result from the activity performed of manufacturing, producing, constructing, or assembling such property. If such person manufactures, produces, constructs, or assembles more than one type of product, the liability with regard to the consumption or use of one of such products will be considered to result from the activity performed of manufacturing, producing, constructing, or assembling that particular product. For example, the liability of a building contractor, which constructs apartment buildings only in the United States, for the improper construction of, or the failure to construct, an apartment building, will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States. In further illustration, the liability (which is covered by a single policy of insurance) of a domestic corporation, which assembles refrigerators exclusively in the United States and manufactures automobiles both in a foreign country and in the United States through substantial activity carried on in each of such countries, for the negligent manufacturing of a part for one of the automobiles by the foreign branch, will be considered to result from an activity ordinarily carried on in, but partly carried on outside, the United States and will be considered a liability which could arise from activity performed in the United States.

(iv) *Selling activity.* If a person is liable with regard to selling activity performed, such liability will be considered, except as provided in subdivisions (iii), (v), and (vi) of this subparagraph, to result from such selling activity. A person will be considered to be engaged in selling activity if such person engages in an activity resulting in the sale of property. Thus, it is immaterial that, under the Code, such activity would not constitute engaging in or carrying on a trade or business in the country in which such activity is carried on, the property in the goods does not pass in such country, or delivery of the property is not made in such country. For example, if a foreign wholesale distributor, which manages its entire business operations in a foreign country and sells its inventory exclusively in the United States—its only contact in the United States being the promotion of such sales to United States retail outlets by advertising in trade publications and distributing sales catalogues—is liable for a breach of warranty with regard to the sale of property to a United States retail outlet, such liability will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States.

(v) *Liability from service or driving activity*—(*a*) *In general.* If a person is liable with regard to any service activity performed, or is liable with regard to driving activity performed in connection with a motor vehicle, ship or boat, aircraft, or railroad rolling stock, whether or not exclusively used in the commercial transportation of persons or property, such liability will be considered to result from such service or driving activity. For example, if an oil company which drills for oil exclusively in a foreign country is liable with regard to the negligent handling by its employees of explosives in the course of such drilling there, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States. In further illustration, if a corporation which services machinery exclusively in a foreign country under servicing contracts is liable with regard to the negligent repairing of a machine under such a contract, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States.

(*b*) *Location of activities in connection with transportation property.* For purposes of (*a*) of this subdivision, service or driving activity performed in connection with a motor vehicle, ship or boat, aircraft, or railroad rolling stock, whether or not exclusively used in the commercial transportation of persons or property, will be considered activity performed in the United States if the activity is carried on at a time when such property is or will be considered, in accordance with subdivision (iv) or (v) of paragraph (b)(2) of this section, actually in the United States or ordinarily located in the United States. However, if the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such service or driving activity which is carried on at a time when such property is, or will be considered, ordinarily located in the United States can be allocated to, or apportioned between, the risks incurred when such property is actually located in the United States and risks incurred when it is actually located outside the United States, such liability will be considered a liability which could arise from activity performed in the United States only when such property is actually located in the United States. Any allocation or apportionment of premium under the preceding sentence shall be made in accordance with the rules of allocation and apportionment provided in subdivision (iv) or (v) of paragraph (b)(2) of this section. For example, if a person is liable with regard to the performance of services outside the United States in the operation of a motor vehicle which is used exclusively in the commercial transportation of persons to and from the United States and which, because more than 50 percent of the miles traversed during the applicable policy period in the use of such property are traversed within the United States, is considered ordinarily located in the United States, such liability will be considered to be a liability which could not arise from activity performed in the United States only to the extent that the premium which is attributable to the reinsuring or issuing of any insurance contract in connection with such service activity is apportioned on a mileage basis between the risks incurred when such motor vehicle is actually located in the United States and when such vehicle is actually located outside the United States. See paragraph (b)(2)(iv) of this section. In further illustration, if a person is liable with regard to his negligent driving of a motor vehicle which is not used exclusively in the commercial transportation of persons or property, which is registered with any State, and which is driven both in the

United States and a foreign country, such liability will be considered a liability which could arise from activity performed in the United States, unless the premium which is attributable to the reinsuring or issuing of an insurance contract in connection with such driving performed in such motor vehicle ordinarily located in the United States is specifically allocated under the contract to risks incurred with respect to driving performed in, and to risks incurred with respect to driving performed outside, the United States. See paragraph (b)(2)(v) of this section.

(c) *Illustration.* The application of this subdivision may be further illustrated by the following example:

Example. Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations are insurance companies and use the calendar year as the taxable year. Corporation M is exclusively engaged in issuing to owners of commercial rental property which is located in the United States insurance contracts which cover any harm which may be caused in 1963 by the tortious conduct of the owners' employees in managing and maintaining such property. The owners insured under such contracts include both residents and nonresidents of the United States. In 1963, M Corporation cedes to A Corporation one-half of the insurance contracts issued by M Corporation in that year, including the contracts issued to nonresidents. Income of A Corporation derived in 1963 from reinsuring the risks of M Corporation is income from the insurance of United States risks since all the insurance contracts reinsured by it are in connection with a liability which could arise from service activity performed in the United States.

(vi) *Liability from delivery of property.* If the person who is obligated to deliver property is liable with regard to such delivery, such liability will be considered to result from the activity performed of delivering such property. For example, if a corporation which exports all of its inventory from the United States to foreign countries or possessions of the United States is liable with regard to its failure to make delivery outside the United States of inventory it has sold, such liability will be considered to result from an activity exclusively carried on outside the United States and will be considered a liability which could not arise from activity performed in the United States. In further illustration, if a corporation which exports all of its inventory from a foreign country to the United States is liable with regard to its improper delivery in the United States of inventory it has sold, such liability will be considered to result from an activity exclusively carried on in the United States and will be considered a liability which could arise from activity performed in the United States.

(d) *Lives or health of United States residents.* Risks in connection with the lives or health of residents of the United States include those risks which are the subject of insurance contracts referred to in section 801(a), relating to the definition of a life insurance company. If the insured is a resident of the United States at the time the insurance contract is approved, the risk is in connection with the life or health of a resident of the United States for the period of coverage under the contract. However, if during such period of coverage the insured notifies the insurer, or circumstances known to the insurer indicate, that the insured is no longer a resident of the United States, the risk shall cease to be a risk in connection with the life or health of a resident of the United States for the policy period in which the insured gives such notice or such circumstances are known to the insurer, and for each subsequent policy period. Conversely, if the insured is a resident of a particular foreign country at the time the insurance contract is approved, the risk is in connection with the life or health of a resident of such foreign country for the period of coverage under the contract. However, if during such period of coverage the insured notifies the insurer, or circumstances known to the insurer indicate, that the insured is no longer a resident of such foreign country, the risk shall cease to be a risk in connection with the life or health of a resident of such particular foreign country for the policy period in which the insured gives such notice or such circumstances are known to the insurer, and for each subsequent policy period. In determining the country of residence of an insured, the principles of §§ 1.871-2 to 1.871-5, inclusive, and of § 1.913-2(b), relating to the determination of residence and nonresidence in the United States and of foreign residence, shall apply. Citizens of the United States are not residents of the United States merely because of their citizenship. The application of this paragraph may be illustrated by the following example:

Example. Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Corporation A uses the calendar year as the taxable year and is engaged in the life insurance business in foreign country X. In 1963, A Corporation issues ordinary life insurance contracts on the lives of residents of the United States, including one issued on February 1, 1963, to R, a citizen of foreign country Y and a resident of the United States on such date. All activity in connection with the issuing of such contracts is transacted by mail. On May 1, 1963, R abandons his United States residence and establishes residence in foreign country Z. There are no circumstances known to A Corporation that R has changed his residence until R, on March 1, 1964, actually notifies A Corporation of that change. Income of A Corporation for the policy period of February 1, 1963, to January 31, 1964, from issuing such insurance contracts is income derived from the insurance of United States risks. However, income of A Corporation derived for the policy period of February 1, 1964, to January 31, 1965, from R's insurance contract is not income derived from the insurance of United States risks.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 6781, 29 FR 18202, Dec. 23, 1964, as amended by T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§ 1.953-3 Risks deemed to be United States risks.

(a) *Artificial arrangements.* For purposes of paragraph (a) of § 1.953-1, the term "United States risks" also includes under section 953(a)(1)(B) risks which are deemed to be United States risks. They are risks (other than United States risks described in section 953(a)(1)(A) and § 1.953-2) which a controlled foreign corporation reinsures under an insurance or annuity contract, or with respect to which a controlled foreign corporation issues any insurance or annuity contract, in accordance with any arrangement whereby another corporation which is not a controlled foreign corporation receives an amount of premiums (for reinsuring or issuing any insurance or annuity contract in connection with the United States risks described in section 953(a)(1)(A) and § 1.953-2) which is substantially equal to the amount of premiums which the controlled foreign corporation receives under its contracts. Arrangements to which this rule applies include those entered into by the controlled foreign corporation, by its United States shareholders, or by a related person.

(b) *Evidence of arrangements.* The determination of the existence of an arrangement referred to in paragraph (a) of this section shall depend on all the facts and circumstances in each case. In making this determination, it will be recognized that arrangements of this type generally are orally entered into outside the United States and that direct evidence of such an arrangement is not ordinarily available. Therefore, in determining the existence of such an arrangement, consideration will be given to whether or not there is substantial similarity between the type, location, profit margin expected, and loss experience of the risks which the corporation which is not a controlled foreign corporation insures or reinsures and the risks which the controlled foreign corporation insures or reinsures. Further, consideration will be given to the existence of prior similar arrangements between, and the identity of the directors or shareholders of, the corporation which is not a controlled foreign corporation, its shareholders, or related persons and the controlled foreign corporation, its shareholders, or related persons. However, the absence of such prior arrangements or identity of directors or shareholders will not of itself establish the nonexistence of an arrangement referred to in paragraph (a) of this section. In determining whether the amounts received by the controlled foreign corporation and the corporation which is not a controlled foreign corporation are substantially equal, the period in which the controlled foreign corporation receives premiums need not be the same as, or identical in length with, that of the corporation which is not a controlled foreign corporation nor limited to a taxable year of the controlled foreign corporation.

(c) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Controlled foreign corporation A is a wholly owned subsidiary of domestic corporation M. Foreign corporation B is a wholly owned subsidiary of foreign corporation R. All corporations use the calendar year as the taxable year. Corporations M and R, which are not related persons, agree that from July 1, 1963, through December 31, 1963, B Corporation will reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A), and that from January 1, 1964, through June 30, 1964, A Corporation will reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A). The amount of premiums received by A Corporation and B Corporation, respectively, as a result of the agreement are substantially equal. The income of A Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example (2). Assume the same facts as in example (1), except that M and R Corporations also agree, as part of their arrangement, that from July 1, 1964, through December 31, 1964, B Corporation will reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A), and that from January 1, 1965, through June 30, 1965, A Corporation will reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A). The amount of premiums derived by B Corporation from July 1, 1963, through December 31, 1963, under the agreement is not substantially equal to the amount of premiums derived by A Corporation from January 1, 1964, through June 30, 1964, and the amount of premiums derived by B Corporation from July 1, 1964, through December 31, 1964, is not substantially equal to the amount of premiums derived by A Corporation from January 1, 1965, through June 30, 1965. However, the aggregate amount of premiums received by B Corporation under the arrangement is substantially equal to the aggregate amount of premiums received by A Corporation. The income of A Corporation derived in 1964 and 1965 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example (3). Assume the same facts as in example (1), except that foreign corporation C is also a wholly owned subsidiary of R Corporation. Assume that C Corporation uses the calendar year as its taxable year. Assume further that M Corporation and R Corporation agree that from July 1, 1963, through December 31, 1963, B Corporation and C Corporation together will reinsure the United States risks described in section 953(a)(1)(A) of M Corporation. The amount of premiums received by B Corporation in respect of such United States risks is equal to one-third of the amount received by A Corporation in respect of the risks which are not United States risks described in section 953(a)(1)(A), and the amount of premiums received by C Corporation in respect of such United States risks is equal to two-thirds of the amount so received by A Corporation. The income of A Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example (4). Assume the same facts as in example (3), except that controlled foreign corporation D is also a wholly owned subsidiary of M Corporation and uses the calendar year as its taxable year. Assume further that M Corporation and R Corporation agree that in 1964 R Corporation will pay premiums of $300,000 to A Corporation and $700,000 to D Corporation to reinsure all risks of R Corporation which are not United States risks described in section 953(a)(1)(A), and that in 1963 M Corporation will pay premiums of $400,000 to B Corporation and $600,000 to C Corporation to reinsure all risks of M Corporation which are United States risks described in section 953(a)(1)(A). The income of A Corporation and D Corporation derived in 1964 from reinsuring the risks of R Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(B).

Example (5). Controlled foreign corporation A is a wholly owned subsidiary of domestic insurance corporation M. Controlled foreign corporation B is a wholly owned subsidiary of domestic insurance corporation N. All corporations use the calendar year as the taxable year. As a result of an arrangement between M Corporation and N Corporation, in 1963 A Corporation reinsures all the United States risks described in section 953(a)(1)(A) of N Corporation, and B Corporation reinsures all the United States risks described in section 953(a)(1)(A) of M Corporation. The premiums and other consideration received by A Corporation and B Corporation in respect of such reinsurance are not substantially equal. The income of A Corporation and B Corporation in 1962 from reinsuring the risks of N Corporation and M Corporation, respectively, is income derived from the insurance of United States risks described in section 953(a)(1)(A) and is not income derived from the insurance or

United States risks described in section 953(a)(1)(B).

Example (6). Assume the same facts as in example (5), except that B Corporation is not a controlled foreign corporation. The income of A Corporation in 1963 from reinsuring the risks of N Corporation is income derived from the insurance of United States risks described in section 953(a)(1)(A) and is not income derived from the insurance of United States risks described in section 953(a)(1)(B).

[T.D. 6781, 29 FR 18207, Dec. 23, 1964]

§ 1.953-4 Taxable income to which section 953 applies.

(a) *Taxable income defined*—(1) *Life insurance taxable income.* For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies, the term "taxable income" means for purposes of paragraph (a) of § 1.953-1 the gain from operations, as defined in section 809(b) and as modified by this section, derived from, and attributable to, the insurance of United States risks. For purposes of determining such taxable income, the provisions of section 802(b) (relating to the definition of life insurance company taxable income) shall not apply. Determinations for purposes of this subparagraph shall be made without regard to section 501(a).

(2) *Mutual and other insurance taxable income.* For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a mutual insurance company to which part II (sections 821 through 826) of subchapter L of the Code applies or a mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of the Code applies, the term "taxable income" means for purposes of paragraph (a) of § 1.953-1 taxable income, as defined in section 832(a) and as modified by this section, derived from, and attributable to, the insurance of United States risks. Determinations for purposes of this subparagraph shall be made without regard to section 501(a).

(3) *Corporations not qualifying as insurance companies.* For special rules applicable under this section in the case of a controlled foreign corporation which, if it were a domestic corporation, would not qualify as an insurance company, see § 1.953-5.

(b) *Certain provisions inapplicable.* In determining taxable income under this section, the following provisions of subchapter L of the Code shall not apply:

(1) Section 809(d)(4), relating to the operations loss deduction;

(2) Section 809(d)(5), relating to certain nonparticipating contracts;

(3) Section 809(d)(6), relating to certain accident and health insurance and group life insurance;

(4) Section 809(d)(10), relating to small business deduction;

(5) Section 817(b), relating to gain on property held on December 31, 1958, and certain substituted property acquired after 1958; and

(6) Section 832(c)(5), relating to capital losses.

(c) *Computation of reserves required by law*—(1) *Law applicable in determining reserves.* The reserves which will be taken into account as reserves required by law under section 801(b)(2), both in determining for any taxable year whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a)(1) or (2) of this section and in determining taxable income of such corporation for the taxable year under paragraph (a) of this section, shall be the following reserves:

(i) *Reserves required by the law of a State.* The reserves which are required by the law of the State or States to which the insurance business of the controlled foreign corporation is subject, but only with respect to its United States business, if any, which is taxable under section 819(a).

(ii) *Reserves deemed to be required.* To the extent of such controlled foreign corporation's insurance business not taxable under section 819(a)—

(*a*) Except as provided in (*b*) of this subdivision (ii), the reserves which would result if such reserves were determined by applying the minimum standards of the law of New York as if such controlled foreign corporation were an insurance company transacting all of its insurance business (other than its United States business which is taxable under section 819(a)) for such taxable year in such State, and

(*b*) With respect to all risks covered by insurance ceded to such controlled foreign corporation by an insurance company to which apply the provisions of subchapter L of the Code (determined without regard to section 501(a)) and in respect of which an election is made by or on behalf of such controlled foreign corporation to determine its reserves in accordance with this subdivision (b), the amount of reserves against such risks which would result if all of such reserves were determined by applying the law of the State, to which the risks in the hands of such insurance company are subject, as if such controlled foreign corporation were an insurance company engaged in reinsuring such risks in such State.

(2) *Rules of application.* For purposes of subparagraph (1) of this paragraph, the following rules shall apply:

(i) *Life insurance reserves computed on preliminary term basis.* For purposes of determining under paragraph (a) of this section the taxable income of a controlled foreign corporation, an election may be made by or on behalf of such corporation that the amount of reserves which are taken into account as life insurance reserves with respect to contracts for which reserves are computed on a preliminary term basis shall be determined as provided in section 818(c). This election shall apply, subject to section 818(c), to all life insurance reserves of the controlled foreign corporation, whether or not reserves applicable to the United States business taxable under section 819(a). However, reserves determined as provided in section 818(c) shall not be taken into account in determining whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a) (1) or (2) of this section.

(ii) *Actual reserves required.* (*a*) A controlled foreign corporation will be considered to have a reserve only to the extent the reserve has been actually held during the taxable year for which such reserve is claimed.

(*b*) For determining when reserves are required by the law of a State, see paragraph (b) of § 1.801-5 of this chapter.

(iii) *Total reserves to be taken into account.* The total reserves of a controlled foreign corporation shall be taken into account in determining whether such corporation is a controlled foreign corporation described in paragraph (a) (1) or (2) of this section. Therefore, in making such determination, the reserves which, under subparagraph (1)(i) of this paragraph, are required by the law of any State shall be taken into account together with the reserves which, under subparagraph (1)(ii) of this paragraph, are deemed to be required. Moreover, reserves applicable to the reinsuring or the issuing of insurance or annuity contracts of both United States risks and foreign risks shall be taken into account. Finally, except as provided in subdivision (i) of this subparagraph, the reserves which are taken into account in determining whether a controlled foreign corporation is a controlled foreign corporation described in paragraph (a) (1) or (2) of this section shall be the same reserves which are taken into account in determining under paragraph (a) of this section the taxable income of such corporation.

(iv) *Method of comparing reserves when subject to more than one State.* If the insurance business of a controlled foreign corporation is subject to the law of more than one State, the amount of reserves taken into account under subparagraph (1)(i) of this paragraph shall be the amount of the highest aggregate reserve required by any State, determined as provided in paragraph (a) of § 1.801-5 of this chapter.

(d) *Domestic corporation tax attributes.* In determining taxable income of a controlled foreign corporation under this section there shall be allowed, except as provided in section 953(b), this section, and § 1.953-5, the exclusions and deductions from gross income which would be allowed if such corporation were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation. For this purpose, the provisions of sections 819, 821(e), 822(e), 831(b), and 832(d), relating to foreign insurance companies, shall not apply; however, for the exclusion from the taxable income determined under section 953 of amounts derived from sources within the United States, see section 952(b) and paragraph (b) of § 1.952-1. Furthermore, taxable income shall be determined under this section without regard to section 882 (b) and (c), relating to gross income and deductions of a foreign corporation, and without regard to whether the controlled foreign corporation is carrying on an insurance business in the United States. For other rules relating to the determination of gross income and taxable income of a foreign corporation for purposes of subpart F, see § 1.952-2.

(e) *Limitation on certain amounts in respect of United States risks.* In determining taxable income under this section the following amounts shall not, in accordance with section 953(b)(4), be taken into account except to the extent they are attributable to the reinsuring or issuing of any insurance or annuity contract in connection with United States risks described in § 1.953-2 or § 1.953-3:

(1) The amount of premiums determined under section 809(c)(1);

(2) The net decrease in reserves determined under section 809(c)(2);

(3) The net increase in reserves determined under section 809(d)(2); and

(4) The premiums earned on insurance contracts during the taxable year, as determined under section 832(b)(4). For the allocation and apportionment of such amounts to income from the insurance of United States risks, see paragraphs (f) and (g) of this section.

(f) *Items allocated or apportioned*—(1) *Rules of allocation or apportionment.* In determining taxable income under this section, first determine all items of income, expenses, losses, and other deductions which directly relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks, as defined in §§ 1.953-2 and 1.953-3, and allocate such items to the insurance of United States risks. For example, the deductions allowed by section 809(d)(1), relating to death benefits, section 809(d)(3), relating to dividends to policyholders, and section 809(d)(7), relating to the assumption by another person of liabilities under insurance contracts, shall be allocated to the insurance of United States risks to the extent they relate directly to the premiums received for reinsuring or issuing insurance or annuity contracts in connection with United States risks. Next, determine all items of income, expenses, losses, and other deductions which directly relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with foreign risks and allocate such items to the reinsuring of foreign risks. Finally, determine all items of income, expenses, losses, and other deductions which relate to the premiums received for the reinsuring or the issuing of any insurance or annuity contract in connection with both United States risks and foreign risks, and, except as provided in paragraph (g) of this section, apportion such items between the insurance of United States risks and the insurance of foreign risks in the manner prescribed in subparagraph (2) or (3) of this paragraph, as the case may be. As used in this section, the term "foreign risks" means risks which are not United States risks as defined in § 1.953-2 or § 1.953-3.

(2) *Method of apportionment in determination of life insurance taxable income*—(i) *Investment yield and net long-term capital gain.* Unless they can be allocated to the insurance of United States risks, as provided in subparagraph (1) of this paragraph, in determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(1) of this section—

(*a*) The investment yield under section 804(c),

(*b*) The amount (if any) under section 809(b)(1)(B) by which the net long-term capital gain exceeds the net short-term capital loss, and

(*c*) Those deductions allowed under section 809(d) (8), (9), and (12) which relate to gross investment income shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to each of such amounts of investment yield, excess gain, and deductions as the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing any insurance and annuity contracts in connection with United States risks bears to the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing all insurance and annuity contracts. Thus, for example, if the ratio which the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing insurance and annuity contracts in connection with United States risks bears to the sum of the mean of each of the items described in section 810(c) at the beginning and end of the taxable year attributable to reinsuring and issuing all insurance and annuity contracts in one to three, then, unless an allocation to the insurance of United States risks can be made as provided in subparagraph (1) of this paragraph, one-third of each of such amounts of investment yield, excess gain, and deductions shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks, and two-thirds of each of such amounts shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with foreign risks.

(ii) *Other income and deductions*—(*a*) *Amount taken into account.* In determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(1) of this section, all items of income taken into account under section 809(c)(3), relating to other amounts of gross income, and the other deductions allowed under section 809(d)(12) to the extent that such other deductions do not relate to gross investment income shall be apportioned to the reinsuring and issuing of insurance and annuity contracts in connection with United States risks in an amount which bears the same ratio to each of such items of income or of such other deductions as the numerator determined under (*b*) of this subdivision bears to the denominator determined under (*c*) of this subdivision.

(*b*) *Numerator.* The numerator used for purposes of the apportionment under (*a*) of this subdivision shall be an amount which equals the amount determined under (*c*) of this subdivision, but only to the extent that the amount so determined is taken into account under paragraph (e) of this section in determining taxable income for the taxable year.

(*c*) *Denominator.* The denominator used for purposes of the apportionment under (*a*) of this subdivision shall be an amount which equals—

(*1*) The amount of premiums determined under section 809(c)(1) for the taxable year, plus

(*2*) The net decrease in reserves determined under section 809(c)(2) for such year, minus

(*3*) The net increase in reserves determined under section 809(d)(2) for such year.

(iii) *Reserves used in apportionment formula.* The rules for determining which reserves are taken into account in determining the taxable income of a controlled foreign corporation under paragraph (a) of this section shall also apply under subdivision (ii) (*b*) and (*c*) of this subparagraph in determining the net decrease in reserves under section 809(c)(2) or the net increase in reserves under section 809(d)(2). See paragraph (c) of this section.

(3) *Method of apportionment in determination of mutual and other insurance income*—(i) *In general.* In determining a controlled foreign corporation's taxable income for any taxable year under paragraph (a)(2) of this section, any item which is required to be apportioned under subparagraph (1) of this paragraph shall be apportioned to the reinsuring and issuing of insurance and annuity con-

tracts in connection with United States risks in an amount which bears the same ratio to the total amount of such item as the amount of premiums earned on insurance contracts during the taxable year which is required to be taken into account by such corporation under paragraph (e)(4) of this section in determining such taxable income bears to the total amount of all its premiums earned (as determined under section 832(b)(4)) on insurance contracts during the taxable year.

(ii) *Reserves used in apportionment formula.* The principles of subparagraph (2)(iii) of this paragraph shall apply in determining the reserves included in premiums earned on insurance contracts during the taxable year for purposes of subdivision (i) of this subparagraph.

(g) *Separate accounting.* The methods of apportionment prescribed in subparagraphs (2) and (3) of paragraph (f) of this section for determining taxable income under this section shall not apply if the district director determines that the controlled foreign corporation, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed segregation of receipts, expenditures, assets, liabilities, and net worth which clearly reflects the income derived from the reinsuring or issuing of insurance or annuity contracts in connection with United States risks. The district director, in making such determination, shall give effect to any foreign law, satisfactory evidence of which is presented by the United States shareholder to the district, director, which requires a reasonable segregation of those items of income, expense, losses, and other deductions which relate to determining such taxable income.

(h) *Illustration.* The application of paragraphs (e) and (f) of this section may be illustrated by the following example:

Example. Controlled foreign corporation A, incorporated under, and engaged in an insurance business subject to, the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. Corporation M is a life insurance company as defined in section 801(a); A Corporation would, if it were a domestic corporation, be taxable under part I of subchapter L of the Code. In 1963, A Corporation derives income from the insurance of United States risks as a result of reinsuring the life insurance policies issued by M Corporation on lives of residents of the United States. In 1963, A Corporation also issues policies of life insurance on individuals who are not residents of the United States, but its premiums from the reinsuring of United States risks exceed he 5-percent minimum premium requirement prescribed in paragraph (b) of § 1.953-1. Based upon the facts set forth in paragraph (a) of this example, A Corporation for 1963 has taxable income under this section of $40,200, which is attributable to the reinsuring of life insurance contracts in connection with United States risks, determined in the manner provided in paragraphs (b), (c), and (d) of this example.

(a) A summary of the entire operations of A Corporation for 1963, determined under this section as though such corporation were a domestic life insurance company but without applying paragraph (f) of this section, is as follows:

Item	Attributable to all insurance	Attributable to reinsuring U.S. risks	Attributable to insuring foreign risks
Investment Income:			
(1) Investment yield under sec. 804(c)	$90,000	Unallocable	Unallocable
(2) Sum of the mean of each of the items described in sec. 810(c) at beginning and end of 1963	2,500,000	$1,000,000	$1,500,000
(3) Required interest under sec. 809(a)(2)	60,000	25,000	35,000
(4) Deductions allowed under sec. 809(d) (8), (9), and (12) which relate to gross investment income	10,000	Unallocable	Unallocable
Underwriting Income:			
(5) Premiums under sec. 809(c)(1)	600,000	200,000	400,000
(6) Net decrease in reserves under sec. 809(c)(2)	10,000	None	10,000
(7) Net increase in reserves under sec. 809(d)(2)	40,000	40,000	None
(8) Deductions allowed under sec. 809(d) (other than deduction allowed under sec. 809(d)(2) and other than those deductions allowed under sec. 809(d) (8), (9), and (12) which relate to gross investment income):			
(i) allocable	330,000	110,000	220,000
(ii) unallocable	60,000	Unallocable	Unallocable

(b) The unallocable investment yield ($90,000) under paragraph (a)(1) of this example and the unallocable deductions ($10,000) under paragraph (a)(4) relating to gross investment income are apportioned to the reinsuring of United States risks under paragraph (f)(1)(i) of this section in the amounts of $36,000, and $4,000, respectively, determined as follows:

(1) Sum of the mean of each of the items described in sec. 810(c) at beginning and end of 1963, attributable to reinsuring U.S. risks (paragraph (a)(2))	$1,000,000
(2) Sum of the mean of each of the items described in sec. 810(c) at beginning and end of 1963, attributable to all insurance (paragraph (a)(2))	$2,500,000
(3) Ratio of amount under subparagraph (1) to amount under subparagraph (2) ($1,000,000/$2,500,000)	40%
(4) Amount of investment yield attributable to reinsuring of U.S. risks (40% of $90,000)	$36,000
(5) Amount of such deductions attributable to reinsuring of U.S. risks (40% of $10,000)	$4,000

(c) The unallocable deductions ($60,000) under paragraph (a)(8)(ii) of this example which do not relate to gross investment income are apportioned to the reinsuring of United States risks under paragraph (f)(2)(ii) of this section in the amount of $16,800, determined as follows:

(1) The numerator determined under paragraph (f)(2)(ii)(*b*) of this section is $160,000, determined as follows:

(i) Premiums under sec. 809(c)(1) attributable to reinsuring U.S. risks (paragraph (a)(5))	$200,000	
(ii) Plus: Net decrease in reserves under sec. 809(c)(2) attributable to reinsuring U.S. risks (paragraph (a)(6))		$200,000
(iii) Less: Net increase in reserves under sec. 809(d)(2) attributable to reinsuring U.S. risks (paragraph (a)(7))		$40,000
		$160,000

(2) The denominator determined under paragraph (f)(2)(ii)(c) of this section is $570,000, determined as follows:

(i) Premiums under sec. 809(c)(1) attributable to all insurance (paragraph (a)(5))	$600,000	
(ii) Plus: Net decrease in reserves under sec. 809(c)(2) attributable to all insurance (paragraph (a)(6))	10,000	
		$610,000
(iii) Less: Net increase in reserves under sec. 809(d)(2) attributable to all insurance (paragraph (a)(7))		40,000
		$570,000

(3) Ratio which the numerator determined under subparagraph (1) bears to the denominator determined under subparagraph (2) ($160,000/$570,000)—28%.

(4) Amount of deductions attributable to reinsuring of U.S. risks (28% of $60,000)—$16,800.

(d) The taxable income of A Corporation for 1963 which constitutes its income derived from the insurance of United States risks for purposes of paragraph (a) of § 1.953-1 is $40,200, determined as follows:

	Attributable to all insurance		Attributable to reinsuring U.S. risks		Attributable to insuring foreign risks	
Item:						
(1) Investment yield under sec. 804(c) (paragraph (a)(1), unallocable but as apportioned under paragraph (b)(4)	$90,000		$36,000		$54,000	
(2) Less: Required interest under sec. 809(a)(2) (paragraph (a)(3))	60,000		25,000		35,000	
(3) Life insurance company's share of investment yield under sec. 809(b)(1)(A)		$30,000		$11,000		$19,000
Plus sum of:						
(4) Premiums under sec. 809(c)(1) (paragraph (a)(5))	600,000		200,000		400,000	
(5) Net decrease in reserves under sec. 809(c)(2) (paragraph (a)(6))	10,000	610,000	None	200,000	10,000	410,000
Sum determined under sec. 809(b)(1)		640,000		211,000		429,000
Less sum of:						
(6) Net increase in reserves under sec. 809(d)(2) (paragraph (a)(7))	40,000		40,000		None	

	Attributable to all insurance		Attributable to reinsuring U.S. risks		Attributable to insuring foreign risks	
Less sum of						
(7) Deductions allowed under sec. 809(d) (8), (9), and (12) which relate to gross investment income (paragraph (a)(4)), unallocable but as apportioned under paragraph (b)(5)	10,000		4,000		6,000	
(8) Deductions allowed under sec. 809(d) (other than deduction allowed under sec. 809(d)(2) and other than those deductions allowed under sec. 809(d) (8), (9), and (12) which relate to gross investment income) (paragraph (a)(8)):						
(i) allocable	330,000		110,000		220,000	
(ii) unallocable, but as apportioned under paragraph (c)(4)	60,000	440,000	16,800	170,800	43,200	269,200
Gain from operations		200,000		40,200		159,800

[T.D. 6781, 29 FR 18207, Dec. 23, 1964]

§ 1.953-5 Corporations not qualifying as insurance companies.

(a) *In general.* A controlled foreign corporation is not excluded from the application of paragraph (a) of § 1.953-1 because such corporation, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies. Thus, if a controlled foreign corporation reinsures or issues insurance or annuity contracts in connection with United States risks, as defined in § 1.953-2 or § 1.953-3, and satisfies the 5-percent minimum premium requirement prescribed in paragraph (b) of § 1.953-1, such corporation may derive income from the insurance of United States risks even though the primary and predominant business activity of such corporation during the taxable year is not the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

(b) *Income from insurance of United States risks by noninsurance company.* For purposes of paragraph (a) of § 1.953-1, the taxable income derived from the reinsuring or the issuing of any insurance or annuity contract in connection with United States risks by a controlled foreign corporation which, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies shall be determined under § 1.953-4, subject to, and to the extent not inconsistent with, the special rules prescribed in paragraph (c) or (d) of this section, whichever applies.

(c) *Special rules in determining taxable income*—(1) *In general.* The rules prescribed in this paragraph apply in order to exclude from the determination under § 1.953-4 of the taxable income described in paragraph (b) of this section those items of the controlled foreign corporation's gross income and deductions which are not attributable to the reinsuring and issuing of insurance and annuity contracts.

(2) *Life insurance taxable income*—(i) *Amount of investment yield taken into account.* For purposes of determining the taxable income of a controlled foreign corporation which would not be taxable as an insurance company to which subchapter L of the Code applies if it were a domestic corporation but would be taxable as an insurance company to which part I of such subchapter applies if it were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation, the investment yield under section 804(c), the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, and all items of income taken into account under section 809(c)(3) shall be taken into

account, subject to the provisions of paragraphs (e) and (f) of § 1.953-4, in an amount which bears the same ratio to each of such amounts of investment yield, excess gain, and income items, as the case may be, as the numerator determined under subdivision (ii) of this subparagraph bears to the denominator determined under subdivision (iii) of this subparagraph.

(ii) *Numerator.* The numerator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the sum of—

(*a*) The mean of each of the items described in section 810(c) at the beginning and end of the taxable year, determined in accordance with the rules prescribed in paragraph (c) of § 1.953-4 for purposes of determining taxable income of a controlled foreign corporation under paragraph (a) of § 1.953-4,

(*b*) The mean of other liabilities at the beginning and end of the taxable year which are attributable to the reinsuring and issuing of insurance and annuity contracts, and

(*c*) The mean of the earnings and profits accumulated by the controlled foreign corporation at the beginning and end of the taxable year (determined without diminution by reason of any distributions made during the taxable year) which are attributable to the reinsuring and issuing of insurance and annuity contracts.

(iii) *Denominator.* The denominator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the mean of the value of the total assets held by the controlled foreign corporation at the beginning and end of the taxable year, determined by taking assets into account at their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be (a) face value in the case of bills receivable, accounts receivable, notes receivable, and open accounts held by a controlled foreign corporation using the cash receipts and disbursements method of accounting and (b) adjusted basis in the case of all other assets.

(3) *Mutual and other insurance taxable income*—(i) *Amount of insurance income taken into account.* For purposes of determining the taxable income of a controlled foreign corporation which, if it were a domestic corporation, would not be taxable as an insurance company to which subchapter L of the Code applies but which if it were a domestic insurance company engaged in the business of only reinsuring or issuing the insurance or annuity contracts which have been reinsured or issued by such corporation, would be taxable as a mutual insurance company to which part II of subchapter L of the Code applies, or would be taxable as a mutual marine insurance or other insurance company to which part III of subchapter L of the Code applies, the sum of the items of gross income referred to in section 832(b)(1) (except the gross amount earned during the taxable year from underwriting income described in section 832(b)(1)(A)) reduced by the deductions allowable under section 832(c) which are related to such items of gross income shall be taken into account, subject to the provisions of paragraphs (e) and (f) of § 1.953-4, in an amount which bears the same proportion to the sum of such items of gross income reduced by such deductions as the numerator determined under subdivision (ii) of this subparagraph bears to the denominator determined under subdivision (iii) of this subparagraph.

(ii) *Numerator.* The numerator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the sum of—

(*a*) The mean of the controlled foreign corporation's unearned premiums at the beginning and end of the taxable year, determined under section 832(b)(4)(B) and in accordance with the rules prescribed in paragraph (c) of § 1.953-4 for purposes of determining taxable income of a controlled foreign corporation under paragraph (a) of § 1.953-4,

(*b*) The mean of such corporation's unpaid losses at the beginning and end of the taxable year, determined under section 832(b)(5)(B),

(*c*) The mean of the items described in section 810(c)(4) at the beginning and end of the taxable year, to the extent allowable to such corporation under section 832(c)(11), (*d*) The mean of other liabilities at the beginning and end of the taxable year which are attributable to the reinsuring and issuing of insurance and annuity contracts, and

(*e*) The mean of the earnings and profits accumulated by such corporation at the beginning and end of the taxable year (determined without diminution by reason of any distributions made during the taxable year) which are attributable to the reinsuring and issuing of insurance and annuity contracts.

(iii) *Denominator.* The denominator used for purposes of the apportionment under subdivision (i) of this subparagraph shall be the mean of the value of the total assets held by the controlled foreign corporation at the beginning and end of the taxable year, determined in the manner prescribed in subparagraph (2)(iii) of this paragraph.

(d) *Separate accounting.* The special rules prescribed in paragraph (c) of this section shall not apply if the district director determines that the controlled foreign corporation, in good faith and unaffected by considerations of tax liability, regularly employs in its books of account a detailed segregation of receipts, expenditures, assets, liabilities, and net worth which clearly reflects the income derived from the reinsuring or issuing of insurance or annuity contracts. The district director, in making such determination, shall give effect to any foreign law, satisfactory evidence of which is presented by the United States shareholder to the district director, which requires a reasonable segregation of the insurance assets of the controlled foreign corporation.

[T.D. 6781, 29 FR 18211, Dec. 23, 1964]

§ 1.953-6 Relationship of sections 953 and 954.

(a) *Priority of application.* For purposes of determining the subpart F income of a controlled foreign corporation under section 952 for any taxable year, the provisions of section 954, relating to foreign base company income, shall be applied, after first applying section 953, only with respect to income which is not income derived from the insurance of United States risks under section 953. For example, the provisions of section 954 may be applied with respect to the income of a controlled foreign corporation which is not income derived from the insurance of United States risks under section 953 because such corporation does not satisfy the 5-percent minimum premium requirement prescribed in paragraph (b) of § 1.953-1, even though such corporation has taxable income, as determined under § 1.953-4, which is attributable to the reinsuring or the issuing of any insurance or annuity contracts in connection with United States risks. In addition, the provisions of section 954 may apply with respect to the income of a controlled foreign corporation to the extent such income is not allocated or apportioned under § 1.953-4 to the insurance of United States risks.

(b) *Decrease in income not material.* It is not material that the income of a controlled foreign corporation is decreased as a result of the application of paragraph (a) of this section. Thus, in applying § 1.953-4 to the income of a controlled foreign corporation described in paragraph (c)(2) of § 1.953-5 which would, but for paragraph (a) of this section, be subject to the provisions of section 954, there shall be allowed, in determining the taxable income derived from the insurance of United States risks under § 1.953-4, a deduction under section 809(a)(1) for the share of each and every item of investment yield set aside for policyholders; it is not material that in determining foreign base company income such deduction would not be allowed under section 954(b)(5). Further, income of a controlled foreign corporation which is required to be taken into account under section 953 in determining income derived from the insurance of United States risks and would, but for the provisions of paragraph (a) of this section, constitute foreign base company income under section 954 shall not be taken into account under section 954(b)(3)(B) in determining whether foreign base company income exceeds 70 percent of gross income for the taxable year.

(c) *Increase in income not material.* It is not material that the income of a controlled foreign corporation is increased as a result of the application of paragraph (a) of this section. Thus, in applying § 1.953-4 to income of a controlled foreign corporation which would, but for paragraph (a) of this section, be subject to the provisions of section 954, it is not material that the dividends, interest, and gains from the sale or exchange of stock or securities derived from certain investments which would not be included in foreign personal holding company income under section 954(c)(3)(B) are included under section 953 in income derived from the insurance of United States risks. Further, income of a controlled foreign corporation which is required to be taken into account under section 953 in determining income derived from the insurance of United States risks and would, but for paragraph (a) of this section, constitute foreign base company income shall not be excluded under section 954(b)(3)(A) for the taxable year.

[T.D. 6781, 29 FR 18212, Dec. 23, 1964]

§ 1.954-1 Foreign base company income.

(a) *In general.* The subpart F income of a controlled foreign corporation for any taxable year includes its foreign base company income for such taxable year. See section 952(a). The foreign base company income of a controlled foreign corporation consists of the sum of its foreign personal holding company income, as defined in § 1.954-2, its foreign base company sales income, as defined in § 1.954-3, and its foreign base company services income, as defined in § 1.954-4, modified and adjusted in accordance with this section.

(b) *Exclusions from foreign base company income.* Foreign base company income does not include the following items:

(1) *Dividends, interest, and gains from qualified investments in less developed countries.* Foreign base company income does not include (i) dividends and interest, after allowance for deductions properly allocable to such income, received during the taxable year from investments which at the time of receipt are qualified investments in less developed countries and (ii) the excess of gains over losses from the sale or exchange of investments which at the time of sale or exchange are qualified investments in less developed countries, after allowance for deductions properly allocable to such income, but only to the extent the sum of such net dividends, interest, and gains does not exceed the controlled foreign corporation's increase for the taxable year in qualified investments in less developed countries. See section 954(b)(1). See also section 955(b) and § 1.955-2 for definition of the term "qualified investments in less developed countries." See section 954(f) and § 1.954-5 for rules relating to the determination of the increase for a taxable year in qualified investments in less developed countries.

(2) *Income derived from aircraft and ships*—(i) *In general.* Foreign base company income does not include income derived from, or in connection with, (*a*) the use, or hiring or leasing for use, of any aircraft or vessel in foreign commerce or (*b*) the performance of services directly related to the use, or hiring or leasing for use, of any such aircraft or vessel in foreign commerce, after allowance for deductions properly allocable to such income. See section 954(b)(2).

(ii) *Meaning of use in foreign commerce.* For purposes of subdivision (i) of this subparagraph, a vessel or aircraft is used in foreign commerce if it is used in transportation of property or passengers—

(*a*) Between a port (or airport) in the United States or possession of the United States and a port (or airport) in a foreign country, or

(*b*) Between one port (or airport) in a foreign country and another in the same country or between a port (or airport) in a foreign country and one in another foreign country.

A lighter or beacon lightship which serves vessels when so used in foreign commerce shall, to the extent so used, be treated as used in foreign commerce for purposes of subdivision (i) of this subparagraph.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A acts as managing agent for controlled foreign corporation B, a related person which contracts to construct and charter a foreign flag vessel for use in foreign commerce. As managing agent for B Corporation, A Corporation performs a broad range of services relating to use of the vessel, including arranging for, and supervising of, construction and chartering of the vessel, and handling of operating services after construction is completed. Corporation A's services on behalf of B Corporation are performed outside the country under the laws of which A Corporation is organized. The income derived by A Corporation from its management and operating services constitutes income derived in connection with the use of the vessel in foreign commerce.

Example (2). Controlled foreign corporation A owns a foreign flag vessel which it charters under a long-term charter to controlled foreign corporation B, a related person. The vessel is used by B Corporation as a tramp which has no fixed or regular schedule. The vessel carries bulk and packaged cargoes, as well as occasional passengers, under charter parties, contracts of affreightment, or other contracts of carriage. The carriage of cargoes and passengers is between a port in the United States and a port in a foreign country or between a port in one foreign country and another port in the same or a different foreign country. The charter hire paid to A Corporation by B Corporation, and the charter hire and freight and passenger revenue (including demurrage and dead freight) derived by B Corporation, constitute income derived from the use, or hiring or leasing for use, of the vessel in foreign commerce.

Example (3). Controlled foreign corporation A owns a foreign flag tanker which it charters under a long-term bareboat charter to foreign corporation B, a related person, for use in foreign commerce. Corporation B produces oil in a foreign country and ships the oil to other foreign countries and to the United States. The vessel chartered by B Corporation, when not engaged in carrying B Corporation's oil, is used to carry bulk cargoes for unrelated persons in foreign commerce as opportunity offers. Corporation B is forced to lay up the vessel as a result of adverse market developments. The vessel is laid up outside the foreign country under the laws of which A Corporation is organized. Pursuant to the terms of the charter, B Corporation continues to pay charter hire to A Corporation during the period of lay-up. The charter hire received by A Corporation during the period of lay-up constitutes income derived in connection with the use, or hiring or leasing for use, of the vessel in foreign commerce.

(3) *Income of controlled foreign corporations not availed of to substantially reduce income or similar taxes; taxable years ending on or before October 9, 1969*—(i) *General rule.* Foreign base company income does not include any item of gross income if it is established to the satisfaction of the district director that the creation or organization of the controlled foreign corporation receiving such item of gross income does not have the effect of substantially reducing income, war profits, excess profits, or similar taxes with respect to such item. See section 954(b)(4). For taxable years ending after October 9, 1969, see also subparagraph (4) of this paragraph.

(ii) *Foreign personal holding company income.* Creation or organization of a controlled foreign corporation will be considered not to have the effect of substantially reducing income, war profits, excess profits, or similar taxes with respect to an item of foreign personal holding company income described in § 1.954-2, if it can be established that, if such item were the only income of such corporation for the taxable year and the United States shareholder of such corporation were a corporate United States shareholder making a first-tier election (as defined in paragraph (b)(5) of § 1.963-1) to receive a minimum distribution for such year with respect to stock which it directly owns in such controlled foreign corporation, no minimum distribution would be required to be received by such shareholder from such controlled foreign corporation. If the rate of tax imposed by a country for the taxable year with respect to the income of a controlled foreign corporation which is distributed is less than the rate of such tax with respect to its income which is not distributed, this subdivision shall not apply with respect to a corporate United States shareholder to exclude an item of income of such controlled foreign corporation unless the effective rate of tax paid to such country by such controlled foreign corporation on such item of income (after allocable deductions other than income, war profits, excess profits, or similar taxes) for the taxable year of such controlled foreign corporation equals or exceeds 90 percent of a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the United States shareholder within which or with which ends such taxable year of such controlled foreign corporation.

(iii) *Foreign base company sales and services income.* Creation or organization of a controlled foreign corporation will be considered not to have the effect of substantially reducing income, war profits, excess profits, or similar taxes with respect to an item of foreign base company sales income described in § 1.954-3 or an item of foreign base company services income described in § 1.954-4 if the effective rate of such taxes paid to a country or countries for the taxable year in respect to such item of income by the controlled foreign corporation equals or exceeds 90 percent of, or is not as much as 5 percentage points less than—

(*a*) In the case of an item of foreign base company sales income described in § 1.954-3, the lesser of—

(*1*) The effective rate of income, war profits, excess profits, or similar taxes that would have been paid for such year in respect to the item of income to the country which, within the meaning of paragraph (a)(3) of § 1.954-3, is the country of use, consumption, or disposition of the property which is sold, or

(*2*) The effective rate of income, war profits, excess profits, or similar taxes that would have been paid for such year in respect to the item of income to the country which, within the meaning of paragraph (a)(2) of § 1.954-3, is the country of manufacture, production, construction, growth, or extraction of such property,

if, under the law of such country described in this subdivision (*a*), all the income of the corporation for such year had been considered derived from sources therein from doing business through a permanent establishment in such country, received in such country, and allocable to such permanent establishment, and the controlled foreign corporation had been created or organized under the laws of, and managed and controlled in, such country; or

(*b*) In the case of an item of foreign base company services income described in § 1.954-4, the effective rate of income, war profits, excess profits, or similar taxes that would have been paid for the taxable year in respect to the item of income to the country which, within the meaning of paragraph (c) of § 1.954-4, is the country where the services are performed, if, under the law of such country, all the income of the corporation for such year had been considered derived from sources therein from doing business through a permanent establishment in such country, received in such country, and allocable to such permanent establishment, and the controlled foreign corporation had been created or organized under the laws of, and managed and controlled in, such country.

(iv) *Determination of hypothetical tax.* In determining under subdivision (iii) of this subparagraph the effective rate of income, war profits, excess profits, or similar taxes that would have been paid for the taxable year in respect to an item of income to the country described in (*a*) or (*b*) of such subdivision by a controlled foreign corporation, such taxes shall be computed on the basis of the actual facts concerning such corporation (except for the assumptions made under such subdivision as to source, receipt, and allocation of income, type of establishment, place of doing business, and place of creation, management, and control) and by deducting from such item of income all deductions allocable thereto other than income, war profits, excess profits, or similar taxes. Thus, if the laws of the country impose a graduated rate of income tax on income of corporations, such tax shall be computed on the basis of the amount of such corporation's income which would be taken into account for the taxable year in determining the tax under such assumptions but otherwise using the actual facts concerning such corporation. Similarly, if the effective rate of tax which such country imposes differs from class to class of income (whether because the law of such country prescribes a different rate for each such class or does so in effect by prescribing special deductions or credits with respect to such class), the tax in respect of the item of income shall be computed on the basis of the tax which under such assumptions would have been imposed for the taxable year on the class containing such item but otherwise using the actual facts concerning the corporation. Likewise, if the rate of tax imposed by such country on a corporation with respect to income not distributed differs from the rate with respect to its distributed income, the tax in respect of the item of income shall be computed at the effective rate of tax applicable to such corporation for the taxable year, computed on the basis of such assumptions and the distributions actually made for such year by such corporation.

(v) *Other facts and circumstances.* Although a failure to meet the 90-percent test or the 5-percentage-point test described in subdivision (iii) of this subparagraph with respect to an item of foreign base company sales income or foreign base company services income will be regarded as a significant factor, foreign base company income will not include such item if, on the basis of other facts and circumstances, it is established to the satisfaction of the district director that the creation or organization of the controlled foreign corporation receiving such item does not have the effect of substantially reducing income, war profits, excess profits, or similar taxes with respect to such item.

(vi) *Effect of exclusion upon other amounts.* In considering whether the creation or organization of a controlled foreign corporation results in a substantial reduction of income, war profits, excess profits, or similar taxes, the fact that the exclusion of items of income from foreign base company income under this subparagraph results in other items of income being excluded from foreign base company income under section 954(b)(3)(A) and paragraph (d)(1) of this section shall not be taken into account. For example, the fact that 29 percent of a controlled foreign corporation's gross income will be excluded from subpart F income under section 954(b)(3)(A) and paragraph (d)(1) of this section if the remaining 71 percent of the gross income is excluded under section 954(b)(4) and this subparagraph will not prevent the application of section 954(b)(4) and this subparagraph.

(vii) *Branch rule.* The same rules as those set forth in subdivisions (i) to (vi), inclusive, of this subparagraph shall also apply to an item of income derived by a branch or similar establishment of a controlled foreign corporation which is treated as a separate wholly owned subsidiary corporation under section 954(d)(2) and paragraph (b) of § 1.954-3.

(viii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, incorporated under the laws of foreign country X, and controlled foreign corporation B, incorporated under the laws of foreign country Y, are both wholly owned subsidiaries of domestic corporation M. All corporations use the calendar year as the taxable year. In 1963, B Corporation derived foreign base company sales income described in § 1.954-3 when it purchased from A Corporation an article manufactured by A Corporation in country X and sold the article to D Corporation, an unrelated person, for use in foreign country Z. With respect to this item of income, B Corporation paid an income tax to country Y in an amount effectively equal to 26 percent of the income (after allocable deductions other than income or similar taxes) from the transaction. No other income or similar tax was paid by B Corporation with respect to this item. If B Corporation had been incorporated under the laws of country X, it would have paid income tax to country X in an amount effectively equal to 40 percent of the income (after allocable deductions other than income or similar taxes) derived from the purchase and sales transaction. If however, B Corporation had been managed and controlled in country Z, it would have paid income tax to country Z in an amount effectively equal to 30 percent of the income (after allocable deductions other than income or similar taxes) derived from the purchase and sale transaction. Therefore, with respect to this item of income, organization of B Corporation in country Y did not have the effect of substantially reducing income or similar taxes (26 percent being less than 90 percent of 30 percent but not being as much as 5 percentage points less than 30 percent), and foreign base company income if B Corporation does not include income derived from such transaction.

Example (2). Assume the same facts as in example (1), except that B Corporation also derived foreign base company services income described in § 1.954-4 when it performed services in country Z for C Corporation, a related person incorporated under the laws of country Z and also using the calendar year as the taxable year. With respect to this item of income, B Corporation paid an income tax to country Y in an amount effectively equal to 15 percent of the income (after allocable deductions other than income or similar taxes) from the service activity. No other income or similar tax was paid by B Corporation with respect to this item. If B Corporation had been managed and controlled in country Z, it would have paid income tax to country Z in an amount effectively equal to 25 percent of the income (after allocable deductions other than income or similar taxes) from the service activity. Therefore, with respect to this item of income, organization of B Corporation in country Y did have the effect of substantially reducing income or similar taxes (15 percent being less than 90 percent of 25 percent and as much as 5 percentage points less than 25 percent), and the exclusion from foreign base company income provided by section 954(b)(4) will not apply to such item.

Example (3). Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. In 1963, A Corporation derived interest and rent not excluded under section 954(c) (3) or (4). The rate of tax imposed by country X for the taxable year on a corporation of such country with respect to income such corporation distributes for such year is the same as that imposed with respect to its income which is not distributed. With respect to the item of interest, A Corporation paid an income tax to country X in an amount effectively equal to 47 percent of such item (after allocable deductions other than income or similar taxes) and, with respect to the item of rent, paid an income tax to country Y in an amount effectively equal to 40 percent of such item (after allocable deductions other than income or similar taxes). No other income or similar tax was paid by A Corporation with respect to such items. If M Corporation were to elect under § 1.963-1 to receive a minimum distribution for 1963 from A Corporation and if the item of interest were the only income of A Corporation, M Corporation would not be required to receive a minimum distribution from A Corporation (effective foreign tax rate being 47 percent and such a distribution not being required under sec. 963(b)); but, if the rent item were A Corporation's only income, M Corporation would be required to receive a minimum distribution from A Corporation (effective foreign tax rate being 40 percent and such a distribution being required under sec. 963(b)). Therefore, with respect to the item of rent, organization of A Corporation in country X did have the effect of substantially reducing income or similar taxes, and the exclusion from foreign base company income provided by section 954(b)(4) will not apply to such item. With respect to the item of interest, however, the organization of A Corporation in such country did not have the effect of substantially reducing such taxes, and such interest is not included in foreign base company income of A Corporation.

Example (4). Controlled foreign corporation A is incorporated under the laws of foreign country X. Corporation A uses the calendar year as the taxable year. Corporation A has conducted business for a substantial period of years prior to 1963. In 1962, A Corporation is subject, under the laws of country X, to an effective tax rate of 46.6 percent on the income (after allocable deductions other than income or similar taxes) derived from purchasing and selling activities conducted throughout the world. A substantial part of its income for 1962 is derived from transactions in which it purchases from an unrelated person in foreign country Z raw materials produced in country Z and sells them to B Corporation, a related person organized under the laws of foreign country Y, for use in country Y. If A Corporation were incorporated under the laws of country Y, it would pay income and similar taxes to country Y for 1962 in an amount effectively equal to 51.2 percent of the income (after allocable deductions other than income or similar taxes) derived from the sales to B Corporation. If A Corporation were incorporated under the laws of country Z, it would pay income and similar taxes to country Z for 1962 in an amount effectively equal to 52 percent of the income (after allocable deductions other than income or similar taxes) derived from the sales to B Corporation. In 1963, A Corporation also derives a substantial part of its income from transactions in which it purchases from an unrelated person in country Z raw materials produced in country Z and sells them to B Corporation for use in country Y. Effective January 1, 1963, there is a general reduction in income tax rates in country X, so that A Corporation pays an income tax to country X for 1963 in an amount effectively equal to 45 percent of the income (after allocable deductions other than income or similar taxes) from the sales to B Corporation. The income tax laws of countries Y and Z applicable for 1962 remain applicable to 1963 without change. During years both before and after the reduction in country X tax, A Corporation actively conducts a trade or business of purchasing personal property from unrelated persons and selling such property to unrelated persons as well as to B Corporation.

For 1963 the percentage of total income of A Corporation derived from sales of the raw materials to B Corporation and the nature of the raw materials so sold to B Corporation remain substantially unchanged from that for 1962. Although the rate of income and similar taxes paid by A Corporation to country X for 1963 on the income from the sales to B Corporation is less than 90 percent of, and as much as 5 percentage points less than, the rate (51.2 percent) of the income and similar taxes which A Corporation would have paid to country Y on the income from the sales to B Corporation, under subdivision (v) of this subparagraph the other facts and circumstances in this example will establish to the satisfaction of the district director that organization of A Corporation in country X did not have the effect, with respect to the income derived from the sales to B Corporation during 1963, of substantially reducing income or similar taxes. Foreign base company income of A Corporation for 1963 does not include income derived from such sales.

(4) *Income of controlled foreign corporations not availed of to substantially reduce income or similar taxes; taxable years ending after October 9, 1969*—(i) *General rule.* Foreign base company income of a controlled foreign corporation for any taxable year ending after October 9, 1969, does not include any item of gross income received or accrued by such corporation during such year if it is established that both (*a*) the creation or organization of such corporation under the laws of the foreign country or possession of the United States in which it is incorporated, and (*b*) the effecting through such corporation of the transaction which gives rise to such income did not have as a significant purpose a substantial reduction of income, war profits, excess profits, or similar taxes. If the controlled foreign corporation receives or accrues an item of income in respect of which there has been no substantial reduction for the taxable year of income, war profits, excess profits, or similar taxes, it may, without reference to (*a*) or (*b*) of this subdivision, be excluded from foreign base company income under section 954(b)(4) and this subparagraph. On the other hand, if the controlled foreign corporation receives or accrues an item of income in respect of which there has been a substantial reduction for the taxable year of income, war profits, excess profits, or similar taxes, it may not be excluded from foreign base company income under section 954(b)(4) and this subparagraph if there is a failure to satisfy the requirements of either (*a*) or (*b*) of this subdivision. If it is established that the creation or organization of such corporation under the laws of the foreign country or possession of the United States in which it is incorporated did not have as one of its significant purposes a substantial reduction of income, war profits, excess profits, or similar taxes, then only that income may be excluded for the taxable year in respect of which it is established that the effecting through such corporation of the transaction giving rise to such income did not have as one of its significant purposes a substantial reduction of income, war profits, excess profits, or similar taxes. If with respect to the U.S. shareholder the foreign corporation became a controlled foreign corporation by reason of the acquisition of its stock, rather than by reason of its creation or organization under the laws of the foreign country or possession of the United States in which it is incorporated, it must be established, for purposes of (*a*) of this subdivision, that the acquisition of such corporation did not have as one of its significant purposes a substantial reduction of income, war profits, excess profits, or similar taxes.

(ii) *Substantial reduction of income taxes.* For purposes of this subparagraph, a determination as to whether there has been a substantial reduction of income, war profits, excess profits, or similar taxes with respect to an—

(*a*) Item of foreign personal holding company income described in § 1.954-2 shall be made by applying the principles of subparagraph (3)(ii) of this paragraph, or

(*b*) Item of foreign base company sales income described in § 1.954-3 or an item of foreign base company services income described in § 1.954-4 shall be made by applying the principles of subparagraph (3) (iii) and (iv) of this paragraph. For illustrations of cases in which for purposes of this subparagraph it may be determined whether or not there has been a substantial reduction of income, war profits, excess profits, or similar taxes with respect to an item of income, see the examples in subparagraph (3)(viii) of this paragraph.

(iii) *Significant purpose defined.* For purposes of this subparagraph, to be significant a purpose must be important, but it is not necessary that it be the principal purpose or the purpose of first importance.

(iv) *Application of significant purpose test.* For purposes of determining whether the creation or organization of a controlled foreign corporation in a particular foreign country or possession of the United States, or whether the acquisition of a controlled foreign corporation in that country or possession, or whether the effecting of the income-producing transaction through that corporation had as one of its significant purposes a substantial reduction of income, war profits, excess profits, or similar taxes, all the facts and circumstances involved will be taken into account. Among the factors to be considered are the various purposes for the action; the type of business carried on, or to be carried on, by the controlled foreign corporation; the classes of income derived, or to be derived, by such corporation; the frequency with which the particular item of income is derived; the effective rate of tax imposed on such income; the place in which the income-producing transaction occurs or the source of such income; and the location of the persons purchasing the corporation's goods or services. Generally, if the income-producing activity carried on by a controlled foreign corporation takes place within the foreign country or possession of the United States in which the corporation is created or organized, the creation or organization of the corporation in that country or possession will not be considered to have as a significant purpose a substantial reduction of income, war profits, excess profits, or similar taxes.

(v) *Manner of demonstrating lack of tax reduction purpose.* It is the U.S. shareholder's responsibility, in accordance with § 1.964-3 and paragraph (d)(6) of § 1.964-4, to provide the district director with books or records sufficient to verify the gross income excluded from foreign base company income under section 954(b)(4) and this subparagraph. However, if the U.S. shareholder of a controlled foreign corporation desires to establish in respect of a proposed transaction that neither the creation or organization (or acquisition) of such corporation under the laws of the foreign country or possession of the United States in which it is incorporated nor the effecting through such corporation of the transaction giving rise to an item or items of income has as one of its significant purposes a substantial reduction of income, war profits, excess profits, or similar taxes, he may forward a statement setting forth sufficient facts and circumstances to the Commissioner of Internal Revenue, Attention: Income Tax Division, Washington, D.C. 20224, for a ruling. Where the Commissioner determines that a ruling is appropriate, a letter setting forth the Commissioner's determination will be mailed to the taxpayer. If the Commissioner determines that, upon the basis of the facts presented, the exclusion of section 954(b)(4) and this subparagraph applies to the income involved, the taxpayer should retain a copy of the Commissioner's letter as authority for excluding such income from foreign base company income for the taxable year.

(vi) *Other applicable rules.* The principles of subparagraph (3)(vi) of this paragraph, relating to the effect of the exclusion under section 954(b)(4) upon other amounts, and subparagraph (3)(vii) of this paragraph, relating to a branch treated as a separate wholly owned subsidiary corporation, apply for purposes of this subparagraph.

(vii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. A controlled foreign corporation is incorporated under the laws of a foreign country. In the past the controlled foreign corporation has organized a number of other corporations in that country to operate radio and television stations there. The purpose of establishing these other corporations was to form a centrally managed radio and television network. The controlled foreign corporation's stock interest in these other corporations ranges from 10 percent to 100 percent. By reason of its stock interests and for other financial or technical reasons, the controlled foreign corporation has exercised effective practical control over the other corporations. The controlled foreign corporation also has conducted several businesses in the foreign country for a number of years which are related to the communications network it has been attempting to establish. In 1969, the communications agency of the foreign country changes its policy and rules that foreign corporations may not own more than 10 percent of the stock of local communications corporations. Since the controlled foreign corporation is more than 50 percent owned by U.S. persons, it is treated by the communications agency of the foreign country as being subject to this new rule. Because of this policy change, the controlled foreign corporation sells all its shares of stock in the radio and television corporations in the foreign country and realizes capital gains on the sales which are not taxed by the foreign country. Under this subparagraph, these gains are excluded from foreign base company income, since the controlled foreign corporation was organized in the foreign country to actively engage in business in that country and because the acquisition and the sale of the stock of the radio and television corporations by the controlled foreign corporation (rather than by its parent corporation or an affiliated corporation) did not have as one of its significant purposes a substantial reduction of income or similar taxes.

(c) *Gross income and deductions to be taken into account.* For purposes of section 954 and this section, foreign personal holding company income as defined in § 1.954-2, foreign base company sales income as defined in § 1.954-3, and foreign base company services income as defined in § 1.954-4 shall be taken into account in determining foreign base company income after allowance for deductions properly allocable to such categories of income. For determination of gross income and deductions for purposes of section 954, see section 952 and the regulations thereunder. For purposes of this section, expenses, taxes, and other deductions shall first be allocated to items or categories of gross income to which they directly relate; then, expenses, taxes, and other deductions which cannot definitely be allocated to some item or category of gross income shall be ratably apportioned among all items or categories of gross income, except that no expense, tax, or other deduction shall be allocated to an item or category of income to which it clearly does not apply. However, if the foreign base company income of a controlled foreign corporation exceeds 70 percent (as determined under paragraph (d) of this section) of gross income, the entire expenses, taxes, and other deductions shall be taken into account, except expenses, taxes, and other deductions properly allocable to amounts excluded from foreign base company income under the provisions of paragraphs (1), (2), and (4) of section 954(b) and paragraph (b) of this section and expenses, taxes, and other deductions allowable to such controlled foreign corporation under section 882(c) and the regulations thereunder.

(d) *Special rules where foreign base company income is less than 30 percent or more than 70 percent of gross income*—(1) *Less than 30 percent of gross income.* If foreign base company income of a controlled foreign corporation for its taxable year amounts to less than 30 percent of the gross income of such corporation for such year, no amount shall be included in subpart F income, as defined in section 952 and the regulations thereunder, of the controlled foreign corporation as foreign base company income. See section 954(b)(3)(A).

(2) *More than 70 percent of gross income.* If foreign base company income of a controlled foreign corporation for its taxable year amounts to more than 70 percent of the gross income of such corporation for such year, the entire gross income of such corporation for the taxable year shall, except as provided in paragraphs (1), (2), (4), and (5) of section 954(b) and paragraphs (b) and (c) of this section, be treated as foreign base company income. See section 954(b)(3)(B).

(3) *Method of computation.* For purposes of determining the percentage which foreign base company income is of gross income under subparagraphs (1) and (2) of this paragraph—

(i) *Computation of foreign base company income.* The foreign base company income of a controlled foreign corporation shall be determined without giving effect to—

(*a*) The exclusion allowed under section 954(b)(1) and paragraph (b)(1) of this section for dividends, interest, and net gain from qualified investments in less developed countries,

(*b*) The deductions allowed under section 954(b)(5) and paragraph (c) of this section, and

(*c*) The reduction in subpart F income provided in section 970(a) and paragraph (b) of § 1.970-1.

(ii) *Computation of gross income.* The gross income of a controlled foreign corporation for a taxable year shall be determined, with respect to a United States shareholder of such controlled foreign corporation, by excluding distributions received by such corporation which are excluded from such income under section 959(b) with respect to such shareholder.

(4) *Branches of controlled foreign corporations treated as separate corporations.* The 30-percent and 70-percent tests described in subparagraphs (1) and (2) of this paragraph apply to the foreign base company income of each controlled foreign corporation. In addition, if a branch or similar establishment of a controlled foreign corporation is treated as a separate wholly owned subsidiary corporation of such corporation under section 954(d)(2) and paragraph (b) of § 1.954-3, the 30-percent and 70-percent tests apply separately to the income allocated under such paragraph to such branch or similar establishment, to other branches and similar establishments similarly treated, and to the remainder of the controlled foreign corporation. The application of this subparagraph may be illustrated by the following example:

Example. Controlled foreign corporation A is incorporated under the laws of foreign country X. Corporation A manufactures goods in country X, and all the gross income which it derives from the sale of such goods it derives through its branch B in foreign country Y; of such gross income, 80 percent is derived from sales by branch B to C for use in foreign country Z and 20 percent from sales to D for use in country Y. Corporation A and branch B are treated under paragraph (b) of § 1.954-3 as separate corporations for purposes of determining foreign base company sales income. The total gross sales income allocated under paragraph (b) of § 1.954-3 to branch B is $900,000, and such income is not excluded from foreign base company income under section 954(b)(4). The remainder of A Corporation derives total gross income of $4,000,000, consisting of $3,900,000 from operations and of $100,000 from dividends not excluded from foreign base company income. The 30-percent and 70-percent tests of section 954(b)(3) apply to A Corporation and branch B as follows:

A CORPORATION

Gross income attributable to manufacturing operations	$3,900,000
Gross dividend income	100,000
Total gross income	4,000,000

Since foreign base company income of A Corporation, before deductions, is less than 30 percent of gross income of A Corporation ($100,000/$4,000,000, or 2½ percent), no part of its gross income, as determined for purposes of section 954(b)(3), is treated as foreign base company income.

BRANCH B

Gross income attributable to sales operations conducted by Branch B	$900,000
Foreign base company sales income (80 percent of $900,000)	720,000

Since foreign base company sales income of branch B, before deductions, constitutes more than 70 percent of its gross income ($720,000/$900,000, or 80 percent), the entire gross income of $900,000, subject to deductions as provided in section 954(b)(5) and paragraph (c) of this section, is treated as foreign base company income of branch B and is included in the subpart F income of A Corporation under section 952(a). Such amount is not included in the gross income of A Corporation, other than branch B, for purposes of again applying the 30 percent and 70 percent tests of section 954(b)(3) to A Corporation.

(e) *Definition of a related and unrelated person.* For purposes of section 954 and §§ 1.954-1 to 1.954-5, inclusive—

(1) *Related person.* The following persons are considered under section 954(d)(3) to be related persons with respect to a controlled foreign corporation:

(i) *Individuals, etc.* A person who is an individual, partnership, trust, or estate if such individual, partnership, trust, or estate owns, within the meaning of section 958 and the regulations thereunder, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the controlled foreign corporation. This subdivision shall apply whether or not the person is a citizen or resident of the United States or is domestic or foreign as to the United States.

(ii) *Corporations.* A person which is a foreign or domestic corporation if—

(*a*) Such foreign or domestic corporation owns, within the meaning of section 958 and the regulations thereunder, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the controlled foreign corporation,

(*b*) The controlled foreign corporation owns, within the meaning of section 958 and the regulations thereunder, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such foreign or domestic corporation, or

(*c*) More than 50 percent of the total combined voting power of all classes of stock entitled to vote of both such foreign or domestic corporation and the controlled foreign corporation is owned, within the meaning of section 958 and the regulations thereunder, by the same person or persons.

(2) *Unrelated person.* A person is an unrelated person with respect to a controlled foreign corporation if such person is not, within the meaning of subparagraph (1) of this paragraph, a related person with respect to such corporation.

(f) *Classification of an item of income.* For purposes of section 954 and §§ 1.954-1 to 1.954-5, inclusive—

(1) *In accordance with the substance of a transaction.* Items of income shall be classified in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount received as "interest" which actually constitutes rent shall not be classified as "interest" but shall be classified as rent; an amount received as "rent" which actually constitutes income from the sale of property, royalties, or income from services shall not be classified as "rent" but shall be classified as income from the sale of property, royalties, or income from services, respectively. Local law shall not be controlling in classifying an item of income.

(2) *In accordance with predominant characteristic.* All of the income derived by a controlled foreign corporation from the performance of an integrated business transaction shall, unless the United States shareholder of such corporation establishes that a different method is proper, be classified in accordance with the predominant characteristic of the transaction, even though a part of such income could incidentally be imputed to another class of income. Thus, for example, if a controlled foreign corporation derives income under a contract which provides for the rental of property which it owns and also for the furnishing by such corporation of an incidental amount of maintenance services in respect of the rented property, the entire amount of the income derived under such contract shall be treated as rent. If a controlled foreign corporation contracts to provide engineering services consisting of planning a project and incidental to such planning uses its own equipment, or if it contracts to construct a project and does so using its own employees and equipment, the entire income derived under such contract shall be treated as derived from the performance of services. Similarly, if a controlled foreign corporation engaged in manufacturing a product uses a patent or other industrial property right which it owns to manufacture such product, the entire income derived from the manufacturing of such product shall be treated as manufacturing income. If a controlled foreign corporation in its business of purchasing and selling personal property incidentally receives interest on an account receivable arising from such a sale, such interest shall be treated as income derived in connection with the sale of the property although interest on such account, if the account were sold to a finance company, would constitute interest when derived by such company. On the other hand, where a controlled foreign corporation is engaged in performing separate transactions, even though pursuant to the same contract or arrangement, the income from each such transaction shall be separately classified. For example, if a controlled foreign corporation contracts to rent construction equipment and also to furnish engineering services consisting of planning a construction project, the

income derived under such contract shall be treated as derived in part as rent and in part as income from the performance of services.

[T.D. 6734, 29 FR 6387, May 15, 1964, as amended by T.D. 6755, 29 FR 12703, Sept. 9, 1964; 29 FR 12873, Sept. 12, 1964; T.D. 6759, 29 FR 13324, Sept. 25, 1964; T.D. 7211, 37 FR 21435, Oct. 11, 1972; T.D. 7293, 38 FR 32802, Nov. 28, 1973]

§ 1.954-2 Foreign personal holding company income.

(a) *In general.* Foreign personal holding company income of a controlled foreign corporation shall consist of the items of gross income defined in accordance with section 553 and § 1.553-1, relating to foreign personal holding company income, except for the adjustment to rents provided in section 954(c)(2) and paragraph (b) of this section and the exclusions provided in section 954(c) (3) and (4), section 959(b), and paragraphs (c) to (e), inclusive, of this section. However, no amount which would be considered a dividend under section 553, solely by reason of the application of section 555(b), shall constitute foreign personal holding company income under section 954(c) and this section. See section 954(c)(1). See also section 954(b)(5) and paragraph (c) of § 1.954-1 for deductions to be taken into account in determining foreign base company income. As used in this section and unless the context otherwise requires, the term "rent" includes compensation paid for the use or possession of real or personal property; the term "leasing" includes hiring; the term "lease" includes a bailment; and the term "lessor" includes a bailor.

(b) *Rents.* For purposes of paragraph (a) of this section, rents received by a controlled foreign corporation shall, except as provided in paragraphs (d)(1) and (e)(3) of this section, be included in foreign personal holding company income of such corporation without regard to whether or not such rents constitute 50 percent or more of the gross income of such corporation.

(c) *Dividends attributable to amounts previously included in gross income of United States shareholders.* Foreign personal holding company income of a controlled foreign corporation does not include, with respect to a United States shareholder of such corporation, dividends received by such corporation which are excluded under section 959(b) from the income of such corporation with respect to such shareholder.

(d) *Certain income received from unrelated persons in the active conduct of a trade or business*—(1) *Rents and royalties*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation does not include rents and royalties which are derived in the active conduct of a trade or business and received from an unrelated person, as defined in paragraph (e)(2) of § 1.954-1. See section 954(c)(3)(A). Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from the facts and circumstances of each case; but see subdivision (ii) or (iii) of this subparagraph for specific cases in which rents or royalties will be considered for purposes of this subparagraph to be derived in the active conduct of a trade or business. The frequency with which a foreign corporation enters into transactions from which rents or royalties are derived will not of itself establish the fact that such rents or royalties are derived in the active conduct of a trade or business.

(ii) *Rents*—(*a*) *Trade or business cases.* In every case rents will be considered for purposes of this subparagraph to be derived in the active conduct of a trade or business by a controlled foreign corporation which is a lessor of property if such rents are derived from the leasing of—

(*1*) Property which the lessor has manufactured or produced, or has acquired and added substantial value to, but only so long as the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, and leasing of, property of such kind,

(*2*) Real property with respect to which the lessor performs active and substantial management and operational functions while the property is leased,

(*3*) Personal property ordinarily used by the lessor in the active conduct of a trade or business and such leasing occurs during a temporary period when the property would, but for such leasing, be idle in the active conduct of such trade or business, or

(*4*) Property which is leased as a result of the performance of marketing functions by such lessor and the lessor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and which is substantial in relation to the amount of rents derived from the leasing of such property.

(*b*) *Special rules*—(*1*) *Adding substantial value.* For purposes of subdivision (*a*)(*1*) of this subdivision (ii), the performance of marketing functions will not be considered to add substantial value to property.

(*2*) *Substantiality of foreign organization.* Whether an organization in a foreign country will be considered substantial in relation to the amount of rents, for purposes of subdivision (*a*)(*4*) of this subdivision (ii), is to be determined from the facts and circumstances of each case. In every case involving the leasing of personal property, however, an organization in a foreign country will be considered substantial in relation to the amount of rents, for such purposes, if the sum of the deductions incurred by such organization of the lessor which are properly allocable to such rental income and which would be allowable under section 162 to the lessor (were the lessor a domestic corporation) other than—

(*i*) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the lessor,

(*ii*) Deductions for rents paid or accrued, and

(*iii*) Deductions which would be specifically allowable to the lessor under sections other than section 162 (were the lessor a domestic corporation)

equals or exceeds 25 percent of the amount by which the gross income of the lessor from such rental income exceeds the sum of the rents paid or accrued and the amounts which would be allowable to such lessor as deductions under section 167 (were the lessor a domestic corporation) with respect to such rental income.

(*3*) *Activities of an independent contractor.* (*i*) In determining under subdivision (*a*)(*4*) of this subdivision (ii) whether a lessor maintains and operates an organization in a foreign country which is regularly engaged in the business of marketing, or of marketing and servicing, leased property, the activities of an independent contractor shall not be taken into account.

(*ii*) Compensation for the services of an independent contractor may be taken into account under, and subject to the limitations imposed by, subdivision (*2*) of this subdivision (*b*) in determining whether the sum of deductions incurred equals or exceeds 25 percent of the amount by which the gross income exceeds certain deductions.

(*c*) *Illustrations.* The application of this subdivision may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation A is regularly engaged in the production of office machines which it leases to others and services. The rental income of A Corporation from such leases is derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (*2*). Controlled foreign corporation B leases to others motion picture films, some of which it acquires by purchase and some of which it acquires by lease. Corporation B, through its own staff of employees located in a foreign country, maintains and operates an office in such foreign country at which a complete sales force, composed of its own employees, actively solicits customers to lease such films, conducts advertising and sales promotion campaigns intended to increase attendance at the showing of films which it leases, and engages in other promotional activities directed at increasing its contracts for the leasing of such films to others. Corporation B maintains an inventory of films in such country from which its customers may make selections. Corporation B, by its office, sales force, and inventory, maintains and operates an organization in a foreign country which is regularly engaged in the business of marketing motion picture films. The deductions incurred by such organization abroad are such as to satisfy the 25-percent test of subdivision (*b*)(*2*) of this subdivision (ii); thus such organization is substantial in relation to the rents B Corporation receives from leasing the films. The rental income of B Corporation from such leases is derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (3). Controlled foreign corporation D purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, D Corporation owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation D also leases in country X on a long-term basis, generally for a term of one year, motor vehicles which it owns. Under the terms of the long-term leases, D Corporation is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, D Corporation maintains and operates an organization therein which is regularly engaged in the business of marketing and servicing the motor vehicles which are leased. Since such organization is substantial in relation to the rents D Corporation receives from leasing the motor vehicles, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (4). Controlled foreign corporation E owns a complex of apartment buildings which it has acquired by purchase. Corporation E engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to the owner. The rental income of E Corporation from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (5). Controlled foreign corporation F owns a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation F, which has acquired this property by purchase, acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. The rents received by F corporation from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (6). Controlled foreign corporation G owns drilling equipment which it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional temporary periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, G Corporation continues the use of such equipment in the performance of its own drilling contracts. Rents received from the temporary leasing of such idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (7). Controlled foreign corporation H is organized on January 1, 1963, to make and lease motion pictures. In January 1964, H Corporation completes its first picture and shortly thereafter begins to lease such picture. During the succeeding months, the company investigates several scripts, choosing a promising one in September 1964. Thereafter, the star planned for the leading role in the proposed motion picture is found to be unavailable, so the project is discontinued in January 1965. Another period of search for a suitable script is terminated in May 1965, by commissioning an author to write one. The writing requires 7 months, and thereafter H Corporation contracts with performers, prepares filming plans, and makes other preliminary arrangements for the filming of the script. The filming is done during the 6 months ending in January 1967, and leasing of the second completed picture begins shortly thereafter. Corporation H is regularly engaged in the production and leasing of motion pictures, and rents derived by such corporation during this period from the leasing of these two motion pictures are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

(iii) *Royalties—(a) Trade or business cases.* In every case royalties will be considered for purposes of this subparagraph to be derived in the active conduct of a trade or business by a controlled foreign corporation which is a licensor of property if such royalties are derived from the licensing of—

(1) Property which the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, and licensing of, property of such kind, or

(2) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly

engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from the licensing of such property.

(*b*) *Special rules—*(*1*) *Adding substantial value.* For purposes of (*a*)(*1*) of this subdivision (iii), the performance of marketing functions will not be considered to add substantial value to property.

(*2*) *Substantiality of foreign organization.* Whether an organization in a foreign country will be considered substantial in relation to the amount of royalties, for purposes of (a)(2) of this subdivision (iii), is to be determined from the facts and circumstances of each case. In every case involving the leasing of personal property, however, an organization in a foreign country will be considered substantial in relation to the amount of royalties, for such purposes, if the sum of the deductions incurred by such organization of the licensor which are properly allocable to such royalty income and which would be allowable under section 162 to the licensor (were the licensor a domestic corporation) other than—

(*i*) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the licensor,

(*ii*) Deductions for royalties paid or accrued, and

(*iii*) Deductions which would be specifically allowable to the licensor under sections other than section 162 (were the licensor a domestic corporation)

equals or exceeds 25 percent of the amount by which the gross income of the licensor from such royalty income exceeds the sum of the royalties paid or accrued and the amounts which would be allowable to such licensor as deductions under section 167 (were the licensor a domestic corporation) with respect to such royalty income.

(*3*) *Activities of an independent contractor.* (*i*) In determining under (*a*)(*2*) of this subdivision (iii) whether a licensor maintains and operates an organization in a foreign country which is regularly engaged in the business of marketing, or of marketing and servicing, licensed property, the activities of an independent contractor shall not be taken into account.

(*ii*) Compensation for the services of an independent contractor may be taken into account under, and subject to the limitations imposed by, subdivision (*2*) of this subdivision (*b*) in determining whether the sum of deductions incurred equals or exceeds 25 percent of the amount by which the gross income exceeds certain deductions.

(*c*) *Illustrations.* The application of this subdivision may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation A, through its own staff of employees, maintains and operates a research facility in foreign country X. At the research facility, owned by A Corporation, employees of such corporation who are full-time scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, which ultimately result in the issuance of patents which are licensed. Royalties received by A Corporation for the privilege of using patented rights which it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (*2*). Assume that A Corporation in example (1), in addition to receiving royalties for the use of patents which it develops, receives royalties for the use of patents which it acquires by purchase and licenses to others without adding any value thereto. Corporation A generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of A Corporation, that A Corporation has acquired rights under a patent and is interested in licensing its rights. Corporation A does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the purchased patents. The royalties received by A Corporation for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (*3*). Controlled foreign corporation B receives royalties for the use of patents which it acquires by purchase. The primary business of B Corporation, operated on a regular basis, consists of licensing patents which it has purchased "raw" from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, B Corporation, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Royalties received by B Corporation from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (4). Controlled foreign corporation D finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation D also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice which is intended to promote the use of the patented property. Corporation D does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the patents. Royalties received by D Corporation for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

Example (5). Controlled foreign corporation E, incorporated under the laws of foreign country X, is engaged in the music publishing business and derives substantially all of its income from the licensing and turning to account of musical compositions. The rights to exploit such compositions are acquired by license, some from related persons and some from unrelated persons. Corporation E, through its own staff of employees located in country X, maintains and operates an office at which is located its own staff of managerial, technical, administrative, and sales employees. The technical staff translates the lyrics into the language of country X or creates new and different lyrics if the original lyrics are unsuitable in such language or do not appeal to the tastes of the people of country X; the staff then prepares musical arrangements of the composition. The sales force has professional copies of the musical product printed for distribution to professional users; and, in many instances, popular copies printed for sale to the public. The sales force also advertises the musical composition, promotes its use by artists, orchestras, radio and television stations, and phonograph recording companies. Although some of its income is derived from the sale of sheet music, the bulk of its income is from its membership in the performing rights society of country X (from which E Corporation could not derive full benefit were it not incorporated in country X) and from royalties resulting from sales of records. Corporation E, by its staff of managerial, technical, administrative, and sales employees located in country X, maintains and operates an organization in such country which is regularly engaged in the business of marketing such compositions. Since such organization is substantial in relation to the royalties received by E Corporation from the licensing of such musical compositions, such royalties are derived in the active conduct of a trade or business for purposes of section 954(c)(3)(A).

(2) *Dividends, interest, and gain on securities, received in banking or other financing business from unrelated persons*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation does not include dividends, interest, or the excess of gains over losses from sales or exchanges of stock or securities, derived in the conduct of a banking, financing, or similar business if such dividends or interest is received from, or if such sales or exchanges are made to or with, unrelated persons, as defined in paragraph (e)(2) of § 1.954-1. See section 954(c)(3)(B).

(ii) *Definition of banking, financing, or similar business.* A controlled foreign corporation will be considered to be engaged in the conduct of a banking, financing, or similar business for purposes of this subparagraph if it is engaged in business, whether in the United States or in a foreign country or possession of the United States, and the activities of that business consist of any one or more of the following activities carried on in transactions with persons situated within or without the United States—

(A) Receiving deposits of money from the public,

(B) Making personal, mortgage, industrial, or other loans to the public,

(C) Purchasing, selling, negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(D) Issuing letters of credit to the public and negotiating drafts drawn thereunder,

(E) Providing trust services for the public,

(F) Financing foreign exchange transactions for the public, or

(G) Purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof; or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking. Although the fact that the controlled foreign corporation is subjected to the banking and credit laws of a foreign country or possession of the United States shall be taken into account in determining whether it is engaged in the conduct of a banking, financing, or similar business in that country or possession, the character of the business actually carried on during the taxable year therein shall determine whether it is conducting a banking, financing, or similar business therein. A controlled foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or a related person, as defined in paragraph (e)(1) of § 1.954-1, shall not be considered to be engaged in the conduct of a banking, financing, or similar business.

If, in addition to conducting a banking, financing, or similar business, a controlled foreign corporation carries on other business activities, for example, the business of selling or manufacturing goods or merchandise from which it realizes income, gain, or loss or only those dividends, interest, and excess of gains over losses from sales or exchanges of stock or securities, derived in the conduct of the banking, financing, or similar business shall be excluded from foreign personal holding company income of the controlled foreign corporation under section 954(c)(3)(B).

(iii) *Incidental income.* If securities or shares of stock are acquired as an ordinary and necessary incident to the conduct of a banking, financing, or similar business, as defined in paragraph (d)(2)(ii) of this section the dividend and interest income from, and the excess of gains over losses from sales or exchanges of, such securities or stock will be considered to be derived in the conduct of a banking, financing, or similar business for purposes of this subparagraph but only so long as the retention of such property remains an ordinary or necessary incident to the conduct of such business. Thus, the acquisition of a security or stock, acquired as the result of, or in order to prevent, a loss in a banking, financing, or similar business upon a loan contracted in the ordinary course of such business will be considered ordinary and necessary to the conduct of such business, but dividends, interest, gain, or loss on such security or stock will be considered derived or incurred in the conduct of the banking, financing, or similar business only so long as the holding of such security or stock remains an ordinary and necessary incident to the conduct of such business. The term "security," as used in this subdivision, means any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing.

(iv) *Income of foreign corporations owned by Edge Act or Agreement corporations—(a) In general.* Notwithstanding subdivisions (ii) and (iii) of this subparagraph, dividends, interest, or the excess of gains over losses from sales or exchanges of stock or securities, derived by a controlled foreign corporation described in (*b*) of this subdivision will be considered for purposes of this subparagraph to be derived in the conduct of a banking, financing, or similar business.

(*b*) *Foreign corporations included.* A controlled foreign corporation to which (*a*) of this subdivision applies is a controlled foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned within the meaning of section 958(a), or is considered as owned by applying the rules of ownership of section 958(b), by a domestic corporation which is either organized under section 25(a) of the Federal Reserve Act (12 U.S.C. 611-631) or has an agreement or undertaking with the Board of Governors of the Federal Reserve System under section 25 of such Act (12 U.S.C. 601-604a), but only if—

(*1*) All of the stock (except qualifying shares) of the domestic corporation is owned by a national or State bank which is a member of the Federal Reserve System; and

(*2*) For each taxable year of such controlled foreign corporation beginning after December 31, 1962, not more than 20 percent of the gross income (determined before the application of paragraph (*d*) of § 1.954-1) of such corporation consists of—

(*i*) Foreign personal holding company income, determined as provided in § 1.954-2 but by excluding from such foreign personal holding company income dividends, interest, and the excess of gains over losses from sales or exchanges of stock or securities,

(*ii*) Foreign base company sales income, as defined in § 1.954-3, and

(*iii*) Foreign base company services income, as defined in § 1.954-4.

(3) *Dividends, interest, and gains on securities derived by insurance companies from investments of unearned premiums or reserves*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation which is an insurance company does not include certain income, determined under subdivision (iii) of this paragraph (d)(3), derived from investments made by the company of its unearned premiums or reserves which are ordinary and necessary for the proper conduct of its insurance business. Although the name, charter powers and subjection to the insurance laws of a foreign country are significant in determining the business which a controlled foreign corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is an insurance company for purposes of section 954(c)(3)(B). The term "unearned premium," as used in this paragraph (d)(3), means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance.

(ii) *Reserves which are ordinary and necessary.* In determining, for purposes of this subparagraph, whether a reserve is ordinary and necessary for the proper conduct of an insurance business, an insurance company will be permitted to make use of the highest reserve which it is required to maintain with respect to such business by a foreign country or State or possession of the United States, in which it carries on insurance business. If no jurisdiction in which an insurance company carries on its insurance business requires a reserve to be maintained, the district director may require the United States shareholder of such insurance company to submit such detailed information with respect to such company's actual experience as is deemed necessary to establish that the reserve is ordinary and necessary for the proper conduct of its insurance business; however, for this purpose, reserves which are determined on the basis of recognized mortality or morbidity tables and assumed rates of interest will generally be accepted by the district director as being ordinary and necessary. For purposes of this subparagraph, a reserve must actually be held by the insurance company for the taxable year (or for such part of such year as may be applicable) for which the reserve is claimed in order to be considered ordinary and necessary for the proper conduct of the insurance business. Notwithstanding the foregoing provisions of this subdivision, a reserve will be considered ordinary and necessary for the proper conduct of the insurance business for purposes of this subparagraph if, assuming the controlled foreign corporation were for the taxable year an insurance company to which section 953 applies for such year, such reserve would be taken into account in determining the taxable income of such corporation for such year under paragraph (a) of § 1.953-4.

(iii) *Amount of exclusion.* The maximum amount eligible for the exclusion under section 954(c)(3)(B) and subdivision (i) of this paragraph (d)(3) is an amount equal to the eligible income (as defined in subdivision (iv) of this paragraph (d)(3)) of a controlled foreign corporation which is an insurance company multiplied by a fraction. The numerator of the fraction is the mean of the corporation's unearned premiums or reserves described in subdivision (ii) of this paragraph (d)(3) at the beginning and end of its taxable year. The denominator of the fraction is the mean of the reserve assets held by the corporation at the beginning and end of its taxable year. Reserve assets are assets which may give rise to foreign personal holding company income described in section 954(c)(1) (without regard to modifications and adjustments under section 954(c) (3) and (4)). The amount of reserve assets attributable to real property and stock is determined on the basis of their fair market value. Any other reserve assets are taken into account on the basis of their adjusted basis for purposes of determining gain on their sale, exchange, or other disposition.

(iv) *Eligible income.* Eligible income equals the total amount of the dividends, interest, and the excess of gains over losses from sales or exchanges of stock or securities, reduced by the following amounts:

(A) The dividends, interest, and the excess of gains over losses described in this paragraph (d)(3)(iv) which are taxed under section 952(a)(1). See section 953 and § 1.953-1(a). This reduction is apportioned ratably between dividends and interest received from, and the excess of gains over losses from sales or exchanges to or with, related and unrelated persons (as defined in § 1.954-1(e)); and

(B) The dividends, interest, and the excess of gains over losses described in this paragraph (d)(3)(iv) which are received from, or derived from sales or exchanges to or with, related persons (as defined in § 1.954-1(e)(1)). The amount of the income described in this paragraph (d)(3)(iv)(B) which is received or derived from related persons does not include income described in subdivision (iv)(A) of this paragraph (d)(3) which is considered to be received or derived from related persons.

(v) *Effective date.* Subdivisions (iii) and (iv) of this paragraph (d)(3) apply to taxable years of controlled foreign corporations beginning after April 23, 1979, and for taxable years of United States shareholders whose taxable years end with or within those taxable years of the controlled foreign corporations. For taxable years of a controlled foreign corporation beginning before April 24, 1979, the amount of the exclusion under this paragraph (d)(3) may be determined under any reasonable method.

(4) *Dividends, interest, and gains on securities derived by insurance companies from investments of earned premiums*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation which is an insurance company does not include certain income, determined under subdivision (ii) of this paragraph (d)(4), derived from investments made by the corporation of an amount of its assets equal to one-third of certain of its earned premiums. For purposes of determining whether a controlled foreign corporation is an insurance company, see paragraph (d)(3)(i) of this section. This paragraph (d)(4) applies to taxable years of controlled foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders whose taxable years end with or within those taxable years of the controlled foreign corporations.

(ii) *Amount of exclusion.* The maximum amount eligible for the exclusion under section 954(c)(3)(C) and subdivision (i) of this paragraph (d)(4) is determined in the same manner, and with respect to the same amounts, as described in paragraph (d)(3)(iii) of this section with the following exception. The numerator of the fraction described in paragraph (d)(3)(iii) of this section is an amount equal to one-third of earned premiums. Subdivision (iii) of this paragraph (d)(4) defines the term "earned premiums."

(iii) *Earned premiums.* Earned premiums are premiums earned on insurance contracts (other than life insurance and annuity contracts) during the taxable year and which are described in section 832(b)(4), other than premiums which are directly or indirectly attributable to the insurance or reinsurance of risks of related persons (as defined in § 1.954-1 (e)(1)). In determining whether premiums are directly or indirectly so attributable, see subdivision (iv) of this paragraph (d)(4).

(iv) *Insurance or reinsurance of risks of related persons.* A premium is directly or indirectly attributable to the insurance or reinsurance of a risk of a related person if the premium is derived by an insurance company from the assumption or sharing of the risk of a related person upon an insurance or reinsurance policy issued to or by the related person or from an arrangement by which all or a part of the policy risk of a related person is in effect transferred directly or indirectly through an unrelated person to the insurance company. If an insurance company participates in an insurance or reinsurance pool, whether there is joint liability on the risk with a related person is not determinative of whether the insurance company insured or reinsured the risk of a related person. If a premium is attributable in part to the insurance or reinsurance of a risk of a related person, and in part to other risks, the amount of the premium is apportioned on a reasonable basis.

(e) *Certain income received from related persons*—(1) *Dividends and interest received from a related corporation organized under the laws of the same foreign country as the income recipient*—(i) *In general.* Foreign personal holding company income of a controlled foreign corporation does not include dividends or interest received from a related foreign corporation, as defined in paragraph (e)(1)(ii) of § 1.954-1, which (*a*) is created or organized under the laws of the same foreign country as that under the laws of which the controlled foreign corporation is created or organized and (*b*) for its taxable year has a substantial part of the assets, which are used in its trade or business, located in such same foreign country. See section 954(c)(4)(A). Dividends shall be excluded from foreign personal holding company income under this subparagraph only to the extent they are paid out of earnings and profits which are earned or accumulated during a period in which the payer is a related foreign corporation as to the controlled foreign corporation and the requirements of both (*a*) and (*b*) of this subdivision are satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payer is a related foreign corporation as to the controlled foreign corporation and the requirements of (*a*) and (*b*) of this subdivision are substantially satisfied. Whether a substantial part of the assets used by a foreign corporation in a trade or business will be considered to be located in the country under the laws of which such corporation is created or organized will depend on the facts and circumstances of each case. In every case, however, a substantial part of the assets used by a foreign corporation in a trade or business will be considered to be located for the taxable year in the country under the laws of which it is created or organized if for each quarter during such taxable year the average value of its assets which are used in the trade or business and are located in such country constitute 80 percent or more of the average value of all its assets used in such trade or business. For such purpose the value at which bills receivable, accounts receivable, notes receivable, and open accounts held by a foreign corporation using the cash receipts and disbursements method of accounting shall be taken into account is their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their face value; and the value at which other assets shall be taken into account is their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(ii) *Location of assets.* For purposes of this subparagraph, property (other than stock in trade or other property of a kind which would properly be included in inventory of the foreign corporation if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the trade or business of the foreign corporation) purchased for use in a trade or business and temporarily located outside the country under the laws of which the foreign corporation is created or organized will be considered located in such country while temporarily located outside such country if, but only if, such property is shipped to and received in such country promptly after such purchase. Bills receivable, accounts receivable, notes receivable, and open accounts shall be considered to be used in the trade or business and located in the country under the laws of which the foreign corporation is created or organized if, but only if—

(*a*) Such obligations arise out of the rental of property located in such country, the performance of services within such country, or the sale of property manufactured, produced, grown, or extracted in such country, but only to the extent that the aggregate amount of such obligations at any time during the taxable year of such corporation does not exceed an amount which is ordinary and necessary to carry on the business of both parties to the transactions if such transactions are between unrelated persons or, if such transactions are between related persons, an amount which would be ordinary and necessary to carry on the business of both parties to the transactions if such transactions were between unrelated persons; or

(*b*) In the case of bills receivable, accounts receivable, notes receivable, and open accounts arising out of transactions other than those referred to in (*a*) of this subdivision—

(*1*) If the obligor is an individual, such individual is a resident of such country and no other country;

(*2*) If the obligor is a corporation which as to the foreign corporation is a related person, as defined in paragraph (e)(1) of § 1.954-1, such obligor derives 80 percent or more of its gross income, for the 3-year period ending with the close of its annual accounting period in which the obligation is incurred, or for such part of such 3-year period as such corporation has been in existence, whichever period is shorter, from sources within such country as determined under the provisions of sections 861 through 864 and §§ 1.861-1 through 1.863-5, in the application of which the name of such country shall be substituted for "the United States"; or

(*3*) If the obligor is a corporation which as to the foreign corporation is an unrelated person, as defined in paragraph (e)(2) of § 1.954-1, it is reasonable, on the basis of ascertainable facts, for the obligee to believe that the obligor meets, with respect to the period described in (*2*) of this subdivision, the 80-percent gross income requirement described therein.

Interests in real estate, such as, leaseholds of land or improvements thereon, mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and mineral, oil, or gas interests shall be considered located in the country under the laws of which the foreign corporation is created or organized if, but only if, the underlying real estate is located in such country. Intangible property (other than that previously described in this subdivision) used in the trade or business of the foreign corporation shall be considered to be located in such country in the same ratio that the amount of the foreign corporation's tangible property and property described in the two preceding sentences used in its trades or businesses and located or deemed located in such country bears to the total amount of its tangible property and property so described used in its trades or businesses.

(2) *Interest received in banking, financing, or similar business from a related person.* Foreign personal holding company income of a controlled foreign corporation does not include interest received in the conduct of a banking, financing, or similar business if such interest is received from a related person, as defined in paragraph (e)(1) of § 1.954-1, if the related person is engaged in the conduct of a banking, financing, or similar business and if the businesses of the recipient and the payer are predominantly with unrelated persons, as defined in paragraph (e)(2) of § 1.954-1. See section 954(c)(4)(B). For purposes of this subparagraph, the businesses of the recipient and the payer of interest will be considered to be predominantly with unrelated persons for a taxable year if both the recipient and the payer each receive more than 70 percent of their gross income for the taxable year from unrelated persons. Determinations as to compliance with such 70-percent test shall be made for the taxable year of the controlled foreign corporation in which the interest is received and for the taxable year of the related person in which the inter-

est is paid. The rules provided in paragraph (d)(2) of this section shall apply under this subparagraph for purposes of determining whether a person is engaged in the conduct of a banking, financing, or similar business and whether interest is received in the conduct of such business. The application of this subparagraph may be illustrated by the following example:

Example. Controlled foreign corporation M is organized under the banking laws of foreign country X. M's sole business activity consists of transactions with the public in which it receives deposits of money and makes loans. In 1974, in the conduct of its banking business M receives 5 percent of its gross interest income from payments made in such year by foreign corporation N, a related person incorporated under the laws of foreign country Y. Both M and N use the calendar year as the taxable year. For 1974, N is engaged in the conduct of a financing business M and N each derive more than 70 percent of their gross income for 1974 from unrelated persons. Interest income of M received from N in 1974 is excluded from M foreign personal holding company income under section 954(c)(4)(B).

(3) *Rents and royalties received from related persons for use of property in country of incorporation.* Foreign personal holding company income of a controlled foreign corporation does not include rents, royalties, and similar amounts received from a related person, as defined in paragraph (e)(1) of § 1.954-1, for the use of, or for the privilege of using, property within the foreign country under the laws of which the controlled foreign corporation is created or organized. See section 954(c)(4)(C). If the property is used both within and without the country under the laws of which the controlled foreign corporation is created or organized, the part of the rent or royalty attributable to the use of, or the privilege of using, the property outside such country of incorporation is, unless otherwise provided, foreign personal holding company income for purposes of section 954(c)(1).

[T.D. 6734, 29 FR 6390, May 15, 1964, as amended by T.D. 6781, 29 FR 18212, Dec. 23, 1964; T.D. 6784, 29 FR 18366, Dec. 24, 1964; T.D. 7497, 42 FR 34875, July 7, 1977; T.D. 7704, 45 FR 42607, June 25, 1980]

§ 1.954-3 Foreign base company sales income.

(a) *Income included*—(1) *In general*—(i) *General rules.* Foreign base company sales income of a controlled foreign corporation shall, except as provided in subparagraphs (2), (3), and (4) of this paragraph, consist of gross income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with (*a*) the purchase of personal property from a related person and its sale to any person, (*b*) the sale of personal property to any person on behalf of a related person, (*c*) the purchase of personal property from any person and its sale to a related person, or (*d*) the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). This section shall apply to the purchase and/or sale of personal property, whether or not such property was purchased and/or sold in the ordinary course of trade or business, except that income derived in connection with the sale of tangible personal property will not be considered to be foreign base company sales income if such property is sold to an unrelated person, as defined in paragraph (e)(2) of § 1.954-1, after substantial use has been made of the property by the controlled foreign corporation in its trade or business. This section shall not apply to the excess of gains over losses from sales or exchanges of securities or from futures transactions, to the extent such excess gains are includible in foreign personal holding company income of the controlled foreign corporation under § 1.954-2; nor shall it apply to the sale of the controlled foreign corporation's property (other than its stock in trade or other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of its trade or business) if substantially all the property of such corporation is sold pursuant to the discontinuation of the trade or business previously carried on by such corporation. The term "any person" as used in this subparagraph includes a related person, as defined in paragraph (e)(1) of § 1.954-1.

(ii) *Special rule—(a) In general.* The term "personal property" as used in section 954(d) and this section shall not include agricultural commodities which are not grown in the United States (within the meaning of section 7701(a)(9)) in commercially marketable quantities. All of the agricultural commodities listed in table I shall be considered grown in the United States in commercially marketable quantities. Bananas, black pepper, cocoa, coconut, coffee, crude rubber, and tea shall not be considered grown in the United States in commercially marketable quantities. All other agricultural commodities shall not be considered grown in the United States in commercially marketable quantities when, in consideration of all of the facts and circumstances of the individual case, such commodities are shown to be produced in the United States in insufficient quantity and quality to be marketed commercially. The term "agricultural commodities" includes, but is not limited to, livestock, poultry, fish produced in fish farms, fruit, furbearing animals as well as the products of truck farms, ranches, nurseries, ranges, and orchards. A fish farm is an area where fish are grown or raised (artificially protected and cared for), as opposed to merely caught or harvested. However, the term "agricultural commodities" shall not include timber (either standing or felled), or any commodity at least 50 percent of the fair market value of which is attributable to manufacturing or processing, determined in a manner consistent with the regulations under section 993(c) (relating to the definition of export property). For purposes of applying such regulations, the term "processing" shall be deemed not to include handling, packing, packaging, grading, storing, transporting, slaughtering, and harvesting. Subdivision (ii) shall apply in the computation of foreign base company sales income for taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders (within the meaning of section 951(b)) within which or with which such taxable years of such foreign corporations end.

(*b*) *Table.*

TABLE I.—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALLY MARKETABLE QUANTITIES

Livestock and Products

Beeswax
Cattle and calves
Chickens
Chicken eggs
Ducks
Geese
Goats
Hogs
Honey
Horses
Milk
Mink
Mohair
Rabbits
Sheep and lambs
Turkeys
Wool

Crops

Alfalfa
Almonds
Apples
Apricots
Artichokes
Asparagus
Avocadoes
Barley
Beans
Beets
Blackberries
Blueberries
Brussel sprouts
Broccoli
Bulbs
Cabbage
Cantaloupes
Carrots
Cauliflower
Celery
Cherries
Corn
Cotton
Cranberries
Cucumbers
Cut flowers
Dates
Eggplant
Escarole
Figs
Filberts
Flaxseed
Garlic
Grapes
Grapefruit
Grass seed
Hay
Honeydew melons
Hops
Lemons
Lettuce
Lime
Macadamia nuts
Maple syrup and sugar
Mint
Mushrooms
Nectarines
Oats
Olives
Onions
Oranges
Papayas
Pecans
Peaches
Peanuts
Pears
Peas
Peppers
Plums and prunes
Potatoes
Potted plants
Raspberries
Rice
Rhubarb
Rye
Sorghum grain
Soybeans
Spinach
Strawberries
Sugar beets
Sugarcane
Sweet potatoes
Tangelos
Tangerines
Tobacco
Tomatoes
Walnuts
Watermelons
Wheat

(iii) The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases from M Corporation, a related person, articles manufactured in the United

States and sells the articles in the form in which purchased to P, not a related person, for delivery and use in foreign country Y. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

Example (2). Corporation A in example (1) also purchases from P, not a related person, articles manufactured in country Y and sells the articles in the form in which purchased to foreign corporation B, a related person, for use in foreign country Z. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

Example (3). Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. By contract, N Corporation agrees to pay C Corporation, a related person, a commission equal to 6 percent of the gross selling price of all personal property shipped by N Corporation as the result of orders solicited by C Corporation in foreign countries Y and Z. In fulfillment of such orders, N Corporation ships products manufactured by it in the United States. Corporation C does not assume title to the property sold. Gross commissions received by C Corporation from N Corporation in connection with the sale of such property for use in countries Y and Z constitute foreign base company sales income.

Example (4). Controlled foreign corporation D, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation R. In 1964, D Corporation acquires a United States manufactured lathe from R Corporation. In 1972, after having made substantial use of the lathe in its manufacturing business, D Corporation sells the lathe to an unrelated person for use in foreign country Z. Gross income from the sale of the lathe is not foreign base company sales income since it is sold to an unrelated person after substantial use has been made of it by D Corporation in its business.

Example (5). Controlled foreign corporation E, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation P. Corporation E purchases from P Corporation articles manufactured by P Corporation outside of country Y and sells the articles to F Corporation, an unrelated person, for use in foreign country Z. Corporation E finances the purchase of the articles by F Corporation by agreeing to accept payment over an extended period of time and receives not only the purchase price but also interest and service fees. All gross income of E Corporation derived in connection with the purchase and sale of the personal property, including interest and service fees derived from financing the sale to F Corporation, constitutes foreign base company sales income.

(2) *Property manufactured, produced, constructed, grown, or extracted within the country in which the controlled foreign corporation is created or organized.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized. See section 954(d)(1) (A). The principles set forth in subparagraph (4) of this paragraph with respect to the manufacture, production, or construction of personal property shall apply under this subparagraph in determining what constitutes manufacture, production, or construction of property. The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases coffee beans grown in country X from foreign corporation P, a related person, and sells the beans to M Corporation, a related person, for use in the United States. Income from the purchase and sale of the coffee beans by A Corporation is not foreign base company sales income since the beans were grown in country X.

Example (2). Controlled foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation C, also incorporated under the laws of country X. Corporation B purchases and imports into country X rough diamonds mined in foreign country Y; in country X it cuts, polishes, and shapes the diamonds in a process which constitutes manufacturing within the meaning of subparagraph (4) of this paragraph. Corporation B sells the finished diamonds to C Corporation, a related person, which in turn sells them for use in foreign country Z. Since for purposes of this subparagraph the finished diamonds are manufactured in country X, gross income derived by C Corporation from their sale is not foreign base company sales income.

(3) *Property sold for use, consumption, or disposition within the country in which the controlled foreign corporation is created or organized*—(i) *In general.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph, (*a*) if the property is sold for use, consumption, or disposition in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or sells on behalf of a related person) is created or organized or (*b*), where the property is purchased by the controlled foreign corporation on behalf of a related person, if such property is purchased for use, consumption, or disposition in the country under the laws of which such controlled foreign corporation is created or organized. See section 954(d)(1) (B).

(ii) *Rules for determining country of use, consumption, or disposition.* As a general rule, personal property which is sold to an unrelated person will be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized. A controlled foreign corporation which sells personal property to a related person is presumed to sell such property for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized unless such corporation establishes the use made of the property by the related person; once it has established that the related person has disposed of the property, the rules in the two preceding sentences relating to sales by a controlled foreign corporation to an unrelated person will apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person. Notwithstanding the preceding provisions of this subdivision, a controlled foreign corporation which sells personal property to any person all of whose business except for an insubstantial part consists of selling from inventory to retail customers at retail outlets all within one country may assume at the time of such sale to such person that such property will be used, consumed, or disposed of within such country.

(iii) *Fungible goods.* For purposes of this subparagraph, a controlled foreign corporation which sells to a purchaser personal property which because of its fungible nature cannot reasonable be specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless such corporation establishes a different disposition as being proper, treat such property as being sold, for ultimate use, consumption, or disposition in those countries, and to those other purchasers, in the same proportions in which property from the fungible mass of the first purchaser is sold in the regular course of business by such first purchaser. No apportionment need be made, however, on the basis of sporadic sales by the first purchaser. This subdivision shall apply only in a case where the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of goods from the fungible mass.

(iv) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, incorporated under the laws of foreign country X, and controlled foreign corporation B, incorporated under the laws of foreign country Y, are related persons. Corporation A purchases from B Corporation electric transformers produced by B Corporation in country Y and sells the transformers to D Corporation, an unrelated person, for installation in a factory building being constructed in country X. Since the personal property purchased and sold by A Corporation is to be used within the country in which A Corporation is incorporated, income of A Corporation derived from the purchase and sale of the electric transformers is not foreign base company sales income.

Example (2). Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation C purchases from N Corporation sewing machines manufactured in the United States by N Corporation and sells the sewing machines to retail department stores, unrelated persons, located in foreign country X. The entire activities of the department stores to which C Corporation sells the machines consist of selling goods from inventory to retail customers at retail outlets in country X. Under these circumstances, at the time of sale C Corporation may assume the sewing machines will be used, consumed, or disposed of in country X, and no attempt need be made by C Corporation to determine where the sewing machines will ultimately be used by the customers of the retail department stores. Gross income of C Corporation derived from the sales to the department stores located in country X is not foreign base company sales income.

Example (3). Controlled foreign corporation D, incorporated under the laws of foreign country Y, and controlled foreign corporation E, incorporated under the laws of foreign country X, are related persons. Corporation D purchases from E Corporation sulphur extracted by E Corporation from deposits located in country X. Corporation D sells the sulphur to F Corporation, an unrelated person, for delivery to F Corporation's storage facilities located in country Y. At the time of the sale of the sulphur from D Corporation to F Corporation, D Corporation knows that F Corporation is actively engaged in the business of selling a large amount of sulphur in country Y but also that F Corporation sells, in the normal course of its business, 25 percent of its sulphur for ultimate consumption in foreign country Z. However, D Corporation has no knowledge at the time of sale whether any portion of the particular shipment it sells to F Corporation will be resold by F Corporation for ultimate use, consumption, or disposition outside country Y. Moreover, delivery of the sulphur to F Corporation's storage facilities constitutes more than a temporary interruption in the shipment of the sulphur. Under such circumstances, D Corporation may, but is not required to, trace the ultimate disposition by F Corporation of the personal property sold to F Corporation; however, if D Corporation does not trace the ultimate disposition and if it does not establish a different disposition as being proper, 25 percent of the sulphur sold by D Corporation to F Corporation will be treated as being sold for consumption in country Z and 25 percent of the gross income from the sale of sulphur by D Corporation to F Corporation will be treated as foreign base company sales income.

Example (4). Controlled foreign corporation G, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation P. Corporation G purchases from P Corporation toys manufactured in the United States by P Corporation and sells the toys to R, an unrelated person, for delivery to a duty-free port in country X. Instructions for the assembly and operation of the toys are printed in a language which is not commonly used in country X. From the facts and circumstances surrounding the sales to R, G Corporation knows, or should know, that the toys will probably not be used, consumed, or disposed of within country X. Therefore, unless G Corporation determines the use to be made of the toys by R, such property will be presumed to have been sold by R for use, consumption, or disposition outside of country X, and the entire gross income of G Corporation derived from the sales will be considered foreign base company sales income.

(4) *Property manufactured or produced by the controlled foreign corporation*—(i) *In general.* Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. A foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased. In the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this

subparagraph are satisfied. For rules of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see subparagraph (5) of this paragraph.

(ii) *Substantial transformation of property.* If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation. The application of this subdivision may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation A, incorporated under the laws of foreign country X, operates a paper factory in foreign country Y. Corporation A purchases from a related person wood pulp grown in country Y. Corporation A, by a series of processes, converts the wood pulp to paper which it sells for use in foreign country Z. The transformation of wood pulp to paper constitutes the manufacture or production of property for purposes of this subparagraph.

Example (*2*). Controlled foreign corporation B, incorporated under the laws of foreign country X, purchases steel rods from a related person which produces the steel in foreign country Y. Corporation B operates a machining plant in country X in which it utilizes the purchased steel rods to make screws and bolts. The transformation of steel rods to screws and bolts constitutes the manufacture or production of property for purposes of this subparagraph.

Example (*3*). Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases tuna fish from unrelated persons who own fishing boats which catch such fish on the high seas. Corporation C receives such fish in country X in the condition in which taken from the fishing boats and in such country processes, cans, and sells the fish to related person D, incorporated under the laws of foreign country Y, for consumption in foreign country Z. The transformation of such fish into canned fish constitutes the manufacture or production of property for purposes of this subparagraph.

(iii) *Manufacture of a product when purchased components constitute part of the property sold.* If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). The application of this subdivision may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation A, incorporated under the laws of foreign country X, sells industrial engines for use, consumption, and disposition outside country X. Corporation A, in connection with the assembly of such engines, performs machining and assembly operations. In addition, A Corporation purchases, from related and unrelated persons, components manufactured in foreign country Y. On a per unit basis, A Corporation's selling price and costs of such engines are as follows:

Selling price			$400
Cost of goods sold:			
Material—			
Acquired from related persons	$100		
Acquired from others	40		
Total material		$140	
Conversion costs (direct labor and factory burden)		70	
Total cost of goods sold			210
Gross profit			190
Administrative and selling expenses			50
Taxable income			140

The conversion costs incurred by A Corporation are more than 20 percent of total costs of goods sold ($70/$210 or 33 percent). Although the product sold, an engine, is not sufficiently distinguishable from the components to constitute a substantial transformation of the purchased parts within the meaning of subdivision (ii) of this subparagraph. A Corporation will be considered under this subdivision to have manufactured the product it sells.

Example (2). Controlled foreign corporation B, incorporated under the laws of foreign country X, operates an automobile assembly plant. In connection with such activity, B Corporation purchases from related persons assembled engines, transmissions, and certain other components, all of which are manufactured outside of country X; purchases additional components from unrelated persons; conducts stamping, machining, and subassembly operations; and has a substantial investment in tools, jigs, welding equipment, and other machinery and equipment used in the assembly of an automobile. On a per unit basis, B Corporation's selling price and costs of such automobiles are as follows:

Selling price			$2,500
Cost of goods sold:			
Material—			
Acquired from related persons	$1,200		
Acquired from others	275		
Total material		$1,475	
Conversion costs (direct labor and factory burden)		25	
Total cost of goods sold			1,800
Gross profit			700
Administrative and selling expenses			300
Taxable income			400

The product sold, an automobile, is not sufficiently distinguishable from the components purchased (the engine, transmission, etc.) to constitute a substantial transformation of purchased parts within the meaning of subdivision (ii) of this subparagraph. Although conversion costs of B Corporation are less than 20 percent of total cost of goods sold ($325/$1800 or 18 percent), the operations conducted by B Corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture of a product. Corporation B will be considered under this subdivision to have manufactured the product it sells.

Example (3). Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases from related persons radio parts manufactured in foreign country Y. Corporation C designs radio kits, packages component parts required for assembly of such kits, and sells the parts in a knocked-down condition to unrelated persons for use outside country X. These packaging operations of C Corporation do not constitute the manufacture, production, or construction of personal property for purposes of section 954(d)(1).

(5) *Rules for apportionment of income derived from the sale of purchased components used in property not manufactured, produced, or constructed.* The foreign base company sales income derived by a controlled foreign corporation for the taxable year from sales of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed by such corporation within the meaning of subparagraph (4) of this paragraph shall, unless the records of the controlled foreign corporation show that a different apportionment of income is proper or unless all the income from such sales is treated as foreign base company sales income, be determined by first making for such year the following separate classifications and subclassifications with respect to the property which is sold and then by apportioning the income for such year from such sales in accordance with the rules of this subparagraph:

(i) A classification of the cost of components used in the property which is sold into two classes consisting of the cost of components manufactured, produced, constructed, grown, or extracted—

(*a*) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(*b*) Outside such country;

(ii) A subclassification of the class described in subdivision (i) (*b*) of this subparagraph into—

(*a*) The cost of such components purchased from unrelated persons, and

(*b*) The cost of such components purchased from related persons;

(iii) A classification of the income derived from such sales into two classes consisting of income derived from sales for use, consumption, or disposition—

(*a*) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(*b*) Outside such country; and

(iv) A subclassification of the class described in subdivision (iii) (*b*) of this subparagraph into income from—

(*a*) Sales to unrelated persons, and

(*b*) Sales to related persons.

The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to unrelated persons shall be the amount which bears to the amount described in subdivision (iv) (*a*) of this subparagraph the same ratio that the amount described in subdivision (ii) (*b*) of this subparagraph bears to the total cost of components used in the product which is sold. The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) (*b*) of this subparagraph the same ratio that the amount described in subdivision (ii) (*b*) of this subparagraph bears to the total cost of components used in the product which is sold.

The foreign base company sales income for the taxable year from purchases of the property from unrelated persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) (*b*) of this subparagraph the same ratio that the amount described in subdivision (ii) (*a*) of this subparagraph bears to the total cost of components used in the product which is sold. The application of this subparagraph may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation C, which is incorporated under the laws of foreign country X, uses the calendar year as the taxable year. For 1964, C Corporation purchases radio parts of which some are manufactured in foreign country Y; and others, in country X. Some of the parts manufactured in country Y are purchased from related persons. Corporation C uses the purchased parts in radio kits which it designs and sells for assembly by its customers, unrelated persons, some of whom use the kits outside country X. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following factual classifications for such year:

Cost of components purchased from all persons:		
Manufactured within country X		$20
Manufactured outside country X		40
Total cost		60
Cost of components manufactured outside country X:		
Purchased from unrelated persons		10
Purchased from related persons		30
Total cost		40
Gross income from sales:		
Gross receipts from sales		120
Cost of goods sold:		
Components	$60	
Direct labor and factory burden	10	70
Gross income		50
Gross income from sales:		
For use within country X		26
For use outside country X		24
Gross income		50
Foreign base company sales income from purchases from related persons and sales to unrelated persons ($24×$30/$60)		12

Example (*2*). The facts are the same as in example (1) except that none of the purchases are from related persons and some of the sales for use outside country X are to related persons. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following additional factual classification for such year:

Gross income from sales for use outside country X—	
To unrelated persons	$8
To related persons	16
Total gross income	24
Foreign base company sales income from purchases from unrelated persons and sales to related persons ($16×$40/$60)	10.67

Example (*3*). The facts are the same as in example (1) except that some of the sales for use outside country X are to related persons as in example (2). Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner:

Foreign base company sales income from purchases from related persons and sales to unrelated persons ($8 × $30/$60)	$4.00
Foreign base company sales income from purchases from related persons and sales to related persons ($16 × $30/$60)	8.00
Foreign base company sales income from purchases from unrelated persons and sales to related persons ($16 × $10/$60)	2.67
Total foreign base company sales income	14.67

(b) *Branches of controlled foreign corporation treated as separate corporations*—(1) *General rules for determining when to apply separate treatment*—(i) *Sales or purchase branch*—(*a*) *In general.* If a controlled foreign corporation carries on purchasing or selling activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2).

(*b*) *Allocation of income and comparison of effective rates of tax.* The determination as to whether such use of the branch or similar establishment has the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to such branch or similar establishment only that income derived by the branch or establishment which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if the income allocated to the branch or similar establishment under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country.

(*c*) *Use of more than one branch.* If a controlled foreign corporation carries on purchasing or selling activities by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, or by or through one or more such branches or similar establishments in a case where subdivision (ii) of this subparagraph also applies, then (*b*) of this subdivision shall be applied separately to the income derived by each such branch or similar establishment (by treating such purchasing or selling branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if any such other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation.

(ii) *Manufacturing branch*—(*a*) *In general.* If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the controlled foreign corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2).

(*b*) *Allocation of income and comparison of effective rates of tax.* The determination as to whether such use of the branch or similar establishment has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to the remainder of such controlled foreign corporation only that income derived by the remainder of such corporation, which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if income allocated to the remainder of the controlled foreign corporation under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the branch or similar establishment is located, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country.

(*c*) *Use of one or more sales or purchase branches in addition to a manufacturing branch.* If, with respect to personal property manufactured, produced, constructed, grown, or extracted by or through a branch or similar establishment located outside the country under the laws of which the controlled foreign corporation is created or organized, purchasing or selling activities are carried on by or through more than one branch or similar establishment, or by or through one or more branches or similar establishments located outside such country, of such corporation, then (*b*) of this subdivision shall be applied separately to the income derived by each such purchasing or selling branch or similar establishment (by treating such purchasing or selling branch or similar establishment as though it alone were the remainder of the controlled foreign corporation) for purposes of determining whether the use of such manufacturing, producing, constructing, growing, or extracting branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation.

(2) *Special rules*—(i) *Determination of treatment as a wholly owned subsidiary corporation.* For purposes of determining under this paragraph whether the use of a branch or similar establishment which is treated as a separate corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of a controlled foreign corporation—

(*a*) *Treatment as separate corporations.* The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(*b*) *Activities treated as performed on behalf of remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities shall—

(*1*) With respect to personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation, or

(*2*) With respect to personal property (other than property described in (*1*) of this subdivision (*b*)) purchased or sold, or purchased and sold, by the controlled foreign corporation,

be treated as performed on behalf of the controlled foreign corporation.

(*c*) *Activities treated as performed on behalf of branch.* With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(*d*) *Determination of hypothetical tax.* To the extent applicable, the principles of paragraph (b)(3)(iv) of § 1.954-1 shall be used in determining, under subdivision (i) of subparagraph (1) of this paragraph, the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the controlled foreign corporation is created or organized, or in determining, under subdivision (ii) of such subparagraph, the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the manufacturing, producing, constructing, growing, or extracting branch or similar establishment is located.

(*e*) *Tax laws to be taken into account.* Tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved.

(ii) *Determination of foreign base company sales income.* Once it has been determined under subparagraph (1) of this paragraph that a branch or similar establishment and the remainder of the controlled foreign corporation are to be treated as separate corporations, the determination of whether such branch or similar establishment, or the remainder of the controlled foreign corporation, as the case may be, has foreign base company sales income shall be made by applying the following rules:

(*a*) *Treatment as separate corporations.* The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(*b*) *Activities treated as performed on behalf of remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities shall—

(*1*) With respect to personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation, or

(*2*) With respect to personal property (other than property described in (*1*) of this subdivision (*b*)) purchased or sold, or purchased and sold, by the controlled foreign corporation,

be treated as performed on behalf of the controlled foreign corporation.

(*c*) *Activities treated as performed on behalf of branch.* With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(*d*) *Items not to be twice included in income.* Income which is classified as foreign base company sales income as a result of the application of subdivision (i) of subparagraph (1) of this paragraph shall not be again classified as foreign base company sales income as a result of the application of subdivision (ii) of such subparagraph.

(e) *Comparison with ordinary treatment.* Income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, shall not be considered foreign base company sales income if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances.

(*f*) *Priority of application.* If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction would be classified as foreign base company sales income of such controlled foreign corporation under section 954(d)(1) and paragraph (a) of this section, the income shall, notwithstanding this paragraph, be treated as foreign base company sales income under paragraph (a) of this section and the branch or similar establishment shall not be treated as a separate corporation with respect to such income.

(3) *Inclusion of amounts in gross income of United States shareholders.* A branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall be treated as separate corporations under this paragraph solely for purposes of determining the foreign base company sales income of each such corporation and for purposes of including an amount in subpart F income of the controlled foreign corporation under section 953(a). See section 954(b)(3) and paragraph (d)(4) of § 1.954-1 for rules relating to the treatment of a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation as separate corporations for purposes of independently determining if the foreign base company income of each such corporation is less than 30 percent, or more than 70 percent, of its gross income. For all other purposes, however, a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall not be treated as separate corporations. For example, if the controlled foreign corporation has a deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includable in the subpart F income of such corporation will apply. Moreover, income, war profits, or excess profits taxes paid by a branch or similar establishment to a foreign country will be treated as having been paid by the controlled foreign corporation for purposes of section 960 (relating to special rules for foreign tax credit) and the regulations thereunder. Also, income of a branch or similar establishment, treated as a separate corporation under this paragraph, will not be treated as dividend income of the controlled foreign corporation of which it is a branch or similar establishment.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in the manufacturing business in such country. Corporation A negotiates sales of its products for use outside of country X through a sales office, branch B, maintained in foreign country Y. These activities constitute the only activities of A Corporation. Country X levies an income tax at an effective rate of 50 percent on the income of A Corporation derived by the manufacturing plant in country X but does not tax the sales income of A Corporation derived by branch B in country Y. Country Y levies an income tax at an effective rate of 10 percent on the sales income derived by branch B but does not tax the income of A Corporation derived by the manufacturing plant in country X. If the sales income derived by branch B were, under the laws of country X, derived from sources within country X by A Corporation, such income would be taxed by such country at an effective rate of 50 percent. In determining foreign base company sales income of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 10 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income. The remainder of A Corporation, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold.

Example (2). Controlled foreign corporation C is incorporated under the laws of foreign country X. Corporation C maintains branch B in foreign country Y. Branch B manufactures articles in country Y which are sold through the sales offices of C Corporation located in country X. These activities constitute the only activities of C Corporation. Country Y levies an income tax at an effective rate of 30 percent on the manufacturing profit of C Corporation derived by branch B but does not tax the sales income of C Corporation derived by the sales offices in country X. Country X does not impose an income, war profits, excess profits, or similar tax, and no tax is paid to any foreign country with respect to income of C Corporation which is not derived by branch B. If C Corporation were incorporated under the laws of country Y, the sales income of the sales offices in country X would be taxed by country Y at an effective rate of 30 percent. In determining foreign base company sales income of C Corporation, branch B is treated as a separate wholly owned subsidiary corporation of C Corporation, the zero rate of tax on the income derived by the remainder of C Corporation being less than 90 percent of, and at least 5 percentage points less than, the 30 percent rate. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold. Income derived by the remainder of C Corporation, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country X of the personal property produced in country Y is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income.

Example (3). Controlled foreign corporation E, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation D, also incorporated under the laws of country X. Corporation E maintains branch B in foreign country Y. Both corporations use the calendar year as the taxable year. In 1964, E Corporation's sole activity, carried on through branch B, consists of the purchase of articles manufactured in country X by D Corporation, a related person, and the sale of the articles through branch B for use outside country X. The income of E Corporation derived by branch B from such transactions is taxed to E Corporation by country X only at the time E Corporation distributes such income to D Corporation and is then taxed on the basis of what the tax (a 40 percent effective rate) would have been if the income had been derived in 1964 by E Corporation from sources within country X from doing business through a permanent establishment therein. Country Y levies an income tax at an effective rate of 50 percent on income derived from sources within such country, but the income of branch B for 1964 is effectively taxed by country Y at a 5 percent rate since, under the laws of such country, only 10 percent of branch B's income is derived from sources within such country. Corporation E makes no distributions to D Corporation in 1964. In determining foreign base company sales income of E Corporation for 1964, branch B is treated as a separate wholly owned subsidiary corporation of E Corporation, the 5 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 40 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of E Corporation, a related person, and constitutes foreign base company sales income.

Example (4). Controlled foreign corporation F, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation F, through its branch B in foreign country Y, purchases from controlled foreign corporation G, a wholly owned subsidiary of M Corporation incorporated under the laws of foreign country Z, personal property which G Corporation manufactures in country Z. Corporation F sells such property for use in foreign country W. Since the income of F Corporation from such purchases and sales is classified as foreign base company sales income under section 954(d)(1) and paragraph (a) of this section, branch B will not be treated as a separate corporation with respect to such income even if the tax differential between countries X and Y would otherwise justify such treatment.

Example (5). Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through its home office, located in country X, and selling such articles through branch B, located in foreign country Y, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office	$200,000		
Branch B		$100,000	
Branch C			$100,000
Income tax	$100,000	$20,000	$20,000
Effective rate of tax	50%	20%	20%

By applying subparagraph (1)(i) of this paragraph and by treating branch B as though it were the only branch of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch B under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country X. Moreover, by applying subparagraph (1)(i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. The income derived by branch B and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country Y and country Z, respectively, is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income for 1963. The home office of A Corporation, treated as a separate corporation, derives no foreign base company sales income for 1963 since it produces the articles which are sold.

Example (6). Controlled foreign corporation A, incorporated under the laws of foreign country X is engaged in manufacturing articles through branch B, located in foreign country Y, and selling such articles through branch C, located in foreign country Z, and through its home office, located in country X, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office	$100,000		
Branch B		$200,000	
Branch C			$100,000
Income tax	$20,000	$100,000	$20,000
Effective rate of tax	20%	50%	20%

In determining foreign base company sales income of A Corporation for 1963 neither branch B nor branch C is treated, by applying subparagraph (1) (i) of this paragraph, as a separate wholly owned subsidiary corporation of A Corporation since branch B derives no income from the purchase or sale of personal property and since, in the case of branch C treated as though it were the only branch of A Corporation, the 20 percent rate of tax on the income of branch C is not less than 90 percent of, and not as much as 5 percentage points less than, the 20 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. However, by applying subparagraph (1) (ii) of this paragraph and by treating the home office in country X as though it alone were the remainder of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of the home office being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of the home office under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country Y. Moreover, by applying subparagraph (1) (ii) of this paragraph and by treating branch C as though it alone were the remainder of A Corporation, branch B and branch C are treated as separate wholly owned subsidiary corporations of A Corporation, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through branch B and branch C were derived from sources within country Y. The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income for 1963. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the articles which are sold.

Example (7). Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through branch B, located in foreign country Y, and selling such articles through the home office, located in country X, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office	$100,000		
Branch B		$200,000	
Branch C			$100,000
Income tax	$40,000	$100,000	$20,000
Effective rate of tax	40%	50%	20%

By applying subparagraph (1) (i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 40 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. In addition, by applying subparagraph (1) (ii) of this paragraph and by treating the home office in country X as though it alone were the remainder of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 40 percent rate of tax on the income of the home office being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of the home office under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country Y. Moreover, by applying subparagraph (1) (ii) of this paragraph and by treating branch C as though it alone were the remainder of A Corporation, branch B and branch C would again be treated as separate wholly owned subsidiary corporations of A Corporation, the 20 percent rate of tax on the income of branch C being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country Y if, under the laws of such country, all the income of A Corporation for 1963 derived through branch B and branch C were derived from sources within country Y; however, for purposes of determining foreign base company sales income of A Corporation for 1963, only the classification under subparagraph (1) (i) of this paragraph shall, by reason of the application of subparagraph (2) (ii) (*d*) of this paragraph, be applied with respect to the income derived by branch C. The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income for 1963. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the articles which are sold.

[T.D. 6734, 29 FR 6392, May 15, 1964, as amended by T.D. 7545, 43 FR 32754, May 8, 1978]

§ 1.954-4 Foreign base company services income.

(a) *Items included.* Except as provided in paragraph (d) of this section, foreign base company services income means income of a controlled foreign corporation, whether in the form of compensation, commissions, fees, or otherwise, derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

(1) Are performed for, or on behalf of a related person, as defined in paragraph (e) (1) of § 1.954-1, and

(2) Are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

(b) *Services performed for, or on behalf of, a related person*—(1) *Specific cases.* For purposes of paragraph (a) (1) of this section, "services which are performed for, or on behalf of, a related person" include (but are not limited to) services performed by a controlled foreign corporation in a case where—

(i) The controlled foreign corporation is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing such services;

(ii) The controlled foreign corporation performs services (whether or not with respect to property sold by a related person) which a related person is, or has been, obligated to perform;

(iii) The controlled foreign corporation performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale; or

(iv) Substantial assistance contributing to the performance of such services has been furnished by a related person or persons.

(2) *Special rules*—(i) *Guaranty of performance.* Subparagraph (1) (ii) of this paragraph shall not apply with respect to services performed by a controlled foreign corporation pursuant to a contract the performance of which is guaranteed by a related person, if (*a*) the related person's sole obligation with respect to the contract is to guarantee performance of such services, (*b*) the controlled foreign corporation is fully obligated to perform the services under the contract, and (*c*) the related person (or any other person related to the controlled foreign corporation) does not in fact (*1*) pay for performance of, or perform, any of such services the performance of which is so guaranteed or (*2*) pay for performance of, or perform, any significant services related to such services. If the related person (or any other person related to the controlled foreign corporation) does in fact pay for performance of, or perform, any of such services or any significant services related to such services, subparagraph (1) (ii) of this paragraph shall apply with respect to the services performed by the controlled foreign corporation pursuant to the contract the performance of which is guaranteed by the related person, even though such payment or performance is not considered to be substantial assistance for purposes of subparagraph (1) (iv) of this paragraph. For purposes of this subdivision, a related person shall be considered to guarantee performance of the services by the controlled foreign corporation whether it guarantees performance of such services by a separate contract of guaranty or enters into a service contract solely for purposes of guaranteeing performance of such services and immediately thereafter assigns the entire contract to the controlled foreign corporation for execution.

(ii) *Application of substantial assistance test.* For purposes of subparagraph (1) (iv) of this paragraph—

(*a*) Assistance furnished by a related person or persons to the controlled foreign corporation shall include, but shall not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.

(*b*) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be considered substantial unless either (*1*) the assistance so furnished provides the controlled foreign corporation with skills which are a principal element in producing the income from the performance of such services by such corporation or (*2*) the cost to the controlled foreign corporation of the assistance so furnished equals 50 percent or more of the total cost to the controlled foreign corporation of performing the services performed by such corporation. The term "cost", as used in this subdivision (*b*), shall be determined after taking into account adjustments, if any, made under section 482.

(*c*) Financial assistance (other than contributions to capital), equipment, material, or supplies furnished by a related person to a controlled foreign corporation shall be considered assistance only in that amount by which the consideration actually paid by the controlled foreign corporation for the purchase or use of such item is less than the arm's length charge for such purchase or use. The total of such amounts so considered to be assistance in the case of financial assistance, equipment, material, and supplies furnished by all related persons shall be compared with the profits derived by the controlled foreign corporation from the performance of the services to determine whether the financial assistance, equipment, material, and supplies furnished by a related person or persons are by themselves substantial assistance contributing to the performance of such services. For purposes of this subdivision (*c*), determinations shall be made after taking into account adjustments, if any, made under section 482 and the term "consideration actually paid" shall include any amount which is deemed paid by the controlled foreign corporation pursuant to such an adjustment.

(*d*) Even though assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how is not considered to be substantial under (*b*) of this subdivision and assistance furnished by a related person or persons in the form of financial assistance (other than contributions to capital), equipment, material, or supplies is not considered to be substantial under (*c*) of this subdivision, such assistance may nevertheless constitute substantial assistance when taken together or in combination with other assistance furnished by a related person or persons which in itself is not considered to be substantial.

(*e*) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be taken into account under (*b*) or (*d*) of this subdivision unless the assistance so furnished assists the controlled foreign corporation directly in the performance of the services performed by such corporation.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (*1*). Controlled foreign corporation A is paid by related corporation M for the installation and maintenance of industrial machines which M Corporation manufactures and sells to B Corporation. Such installation and maintenance services by A Corporation are performed for, or on behalf of, M Corporation for purposes of section 954(e).

Example (*2*). Controlled foreign corporation B enters into a contract with an unrelated person to drill an oil well in a foreign country. Domestic corporation M owns all the outstanding stock of B Corporation. Corporation B employs a relatively small clerical and administrative staff and owns the necessary well-drilling equipment. Most of the technical and supervisory personnel who oversee the drilling of the oil well by B Corporation are regular employees of M Corporation who are temporarily employed by B Corporation. In addition, B Corporation hires on the open market unskilled and semiskilled laborers to work on the drilling project. The services performed by B Corporation under the well-drilling contract are performed for, or on behalf of, a related person for purposes of section 954(e) because the services of the technical and supervisory personnel which are provided by M Corporation are of substantial assistance in the performance of such contract in that they assist B Corporation directly in the execution of the contract and provide B Corporation with skills which are a principal element in producing the income from the performance of such contract.

Example (*3*). Controlled foreign corporation F enters into a contract with an unrelated person to construct a dam in a foreign country. Domestic corporation M owns all the outstanding stock of F Corporation. Corporation F leases or buys from M Corporation, on an arm's length basis, the equipment and material necessary for the construction of the dam. The technical and supervisory personnel who design and oversee the construction of the dam are regular full-time employees of F Corporation who are not on loan from any related person. The principal clerical work, and the financial accounting, required in connection with the construction of the dam by F Corporation are performed, on a remunerated basis, by full-time employees of M Corporation. All other assistance F Corporation requires in completing the construction of the dam is paid for by that corporation and furnished by unrelated persons. The services performed by F Corporation under the contract for the construction of the dam are not performed for, or on behalf of, a related person for purposes of section 954(e) because the clerical and accounting services furnished by M Corporation do not assist F Corporation directly in the performance of the contract.

Example (4). Controlled foreign corporation D, a wholly owned subsidiary of domestic corporation M, procures and enters a contract with an unrelated person to construct a superhighway in a foreign country, but such person enters the contract only on the condition that M Corporation agrees to perform, or to pay for the performance by some person other than D Corporation of, the services called for by the contract if D Corporation should fail to complete their performance. Corporation D is capable of performing such contract. No related person as to D Corporation pays for, or performs, any services called for by the contract, or pays for, or performs, any significant services related to such services. The construction of the superhighway by D Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of M Corporation.

Example (5). Domestic corporation M is obligated under a contract with an unrelated person to construct a superhighway in a foreign country. At a later date M Corporation assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C, and the unrelated person releases M Corporation from any obligation under the contract. The construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example (6). Domestic corporation M enters a contract with an unrelated person to construct a superhighway in a foreign country. Corporation M immediately assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C. The unrelated person does not release M Corporation of its obligation under the contract, the sole purpose of these arrangements being to have M Corporation guarantee performance of the contract by C Corporation. Corporation C is capable of performing the construction contract. Neither M Corporation nor any other person related to C Corporation pays for, or performs, any services called for by the construction contract or at any time pays for, or performs, any significant services related to the services performed under such contract. The construction of the superhighway by C Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example (7). The facts are the same as in example (6) except that M Corporation, preparatory to entering the construction contract, prepares plans and specifications which enable the submission of bids for the contract. Since M Corporation has performed significant services related to the services the performance of which it has guaranteed, the construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example (8). Domestic corporation M manufactures an industrial machine which requires specialized installation. Corporation M sells the machines for a basic price if the contract of sale contains no provision for installation. If, however, the customer agrees to employ controlled foreign corporation E, a wholly owned subsidiary of M Corporation, to install the machine and to pay E Corporation a specified installation charge, M Corporation sells the machine at a price which is less than the basic price. The installation services performed by E Corporation for customers of M Corporation purchasing the machine at the reduced price are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

Example (9). Domestic corporation M manufactures and sells industrial machines with a warranty as to their performance conditional upon their installation and maintenance by a factory-authorized service agency. Controlled foreign corporation F, a wholly owned subsidiary of M Corporation, is the only authorized service agency. Any installation or maintenance services performed by F Corporation on such machines are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

Example (10). Domestic corporation M manufactures electric office machines which it sells at a basic price without any provision for, or understanding as to, adjustment or maintenance of the machines. The machines require constant adjustment and maintenance services which M Corporation, certain wholly owned subsidiaries of M Corporation, and certain unrelated persons throughout the world are qualified to perform. From among the numerous persons qualified and available to perform adjustment and maintenance services with respect to such office machines, foreign corporation B, a customer of M Corporation, employs controlled foreign corporation G, a wholly owned subsidiary of M Corporation, to adjust and maintain the office machines which B Corporation purchases from M Corporation. The adjustment and maintenance services performed by G Corporation for B Corporation are not considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

(c) *Place where services are performed.* The place where services will be considered to have been performed for purposes of paragraph (a) (2) of this section will depend on the facts and circumstances of each case. As a general rule, services will be considered performed where the persons performing services for the controlled foreign corporation which derives income in connection with the performance of technical, managerial, architectural, engineering, scientific, skilled, industrial, commercial, or like services are physically located when they perform their duties in the execution of the service activity resulting in such income. Therefore, in many cases, total gross income of a controlled foreign corporation derived in connection with each service contract or arrangement performed for or on behalf of a related person must be apportioned, between income which is not foreign base company services income and that which is foreign base company services income, on a basis of employee-time spent within the foreign country under the laws of which the controlled foreign corporation is created or organized and employee-time spent without the foreign country under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country under the laws of which the controlled foreign corporation is created or organized, relative weight must also be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial personnel will be assigned greater values in relation to the type of function performed by each individual.

(d) *Items excluded.* Foreign base company services income does not include—

(1) Income derived in connection with the performance of services by a controlled foreign corporation if—

(i) The services directly relate to the sale or exchange of personal property by the controlled foreign corporation,

(ii) The property sold or exchanged was manufactured, produced, grown, or extracted by such controlled foreign corporation, and

(iii) The services were performed before the sale or exchange of such property by the controlled foreign corporation; or

(2) Income derived in connection with the performance of services by a controlled foreign corporation if the services directly relate to an offer or effort to sell or exchange personal property which was, or would have been, manufactured, produced, grown, or extracted by such controlled foreign corporation whether or not a sale or exchange of such property was in fact consummated.

[T.D. 6734, 29 FR 6399, May 15, 1964, as amended by T.D. 6981, 33 FR 16497, Nov. 13, 1968]

§ 1.954-5 Increase in qualified investments in less developed countries.

(a) *Determination of investments at close of current taxable year.* The increase in qualified investments in less developed countries, for purposes of section 954(b) and paragraph (b)(1) of § 1.954-1, of any controlled foreign corporation for any taxable year is, except as provided in paragraph (b) of this section, the amount by which—

(1) The controlled foreign corporation's qualified investments in less developed countries at the close of the taxable year, exceed

(2) Its qualified investments in less developed countries at the close of the preceding taxable year.

See section 954(f). See also section 955(b) and § 1.955-2 for definition of the term "qualified investments in less developed countries". For purposes of this paragraph, a taxable year which begins before January 1, 1963, may be a preceding taxable year.

(b) *Election to determine investments at close of following taxable year*—(1) *General rule.* In lieu of determining an increase in qualified investments in less developed countries for a taxable year in the manner provided in paragraph (a) of this section, a United States shareholder of a controlled foreign corporation may make an election under section 955(b)(3) to determine the increase for the corporation's taxable year by ascertaining the amount by which—

(i) Such corporation's qualified investments in less developed countries at the close of the taxable year immediately following such taxable year, exceed

(ii) Its qualified investments in less developed countries at the close of the taxable year immediately preceding such following taxable year.

(2) *Election with respect to first taxable year.* Notwithstanding subparagraph (1) of this paragraph, if an election is made by a United States shareholder under section 955(b)(3) to determine a controlled foreign corporation's increase in qualified investments in less developed countries for its first taxable year in which such shareholder is a United States shareholder, as defined in section 951(b), with respect to such corporation and such corporation realizes foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954-1, the increase in such controlled foreign corporation's qualified investments in less developed countries for such taxable year shall be an amount by which—

(i) Such corporation's qualified investments in less developed countries at the close of the taxable year immediately following such taxable year, exceed

(ii) Its qualified investments in less developed countries at the close of the taxable year immediately preceding the taxable year for which the election is made.

(3) *Manner of making election.* For the manner of making an election under section 955(b)(3), and for rules pertaining to the revocation of such an election, see § 1.955-3.

(c) *Initial designation of a country as being an economically less developed country.* For purposes of determining the amount of a controlled foreign corporation's qualified investments in less developed countries at the close of the taxable year immediately preceding any taxable year in respect of which a foreign country or possession of the United States has been designated as an economically less developed country, such foreign country or possession shall, with respect to any investment held by such corporation at the close of such preceding taxable year, be deemed to have been designated as an economically less developed country for such preceding taxable year if it has not in fact been so designated, even though such preceding taxable year begins before January 1, 1963. If an increase in a controlled foreign corporation's qualified investments in less developed countries for a taxable year is being determined under paragraph (b)(2) of this section and a foreign country or possession of the United States has been designated as an economically less developed country for the taxable year immediately following such taxable year, such foreign country or possession shall, with respect to any investment held by such corporation at the close of the taxable year immediately preceding the taxable year, be deemed to have been designated, if it has not in fact been so designated, as an economically less developed country for both the taxable year and the taxable year immediately preceding the taxable year. Determinations for purposes of this paragraph with respect to taxable years beginning before January 1, 1963, shall be made by applying the principles of section 955 and the regulations thereunder.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). (i) Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. On December 31, 1962, the assets of A Corporation (determined as provided in paragraph (d) of § 1.955-2) consist of the following amounts:

Cash	$60,000
Bonds:	
U.S. Government bonds	5,000
X Country bonds	15,000
Y Country bonds	20,000
Total bonds	40,000
Stock in foreign corporations:	
100 shares of B Corporation stock	10,000
100 shares of C Corporation stock	40,000
Total stock	50,000
Total assets	150,000

(ii) By Executive order dated December 27, 1962, the President of the United States designates foreign countries Y and Z as economically less developed countries for purposes of sections 951 to 964, inclusive. Foreign corporations B and C use the calendar year as the taxable year, and each such corporation has 100 shares of one class of stock outstanding. For 1962, C Corporation is engaged in the active conduct of a business, derives 90 percent of its gross income (determined by using the principles of § 1.955-6) from sources within country Y, and on each day of the taxable year has 95 percent of the assets which are used in such business located in country Y. If country Y were designated as an economically less developed country for 1962, C Corporation would qualify under the principles of § 1.955-5 as a less developed country corporation for such year. For 1962, B Corporation would not so qualify as a less developed country corporation. By reason of paragraph (c) of this section, A Corporation's qualified investments in less developed countries as of December 31, 1962, amount to $60,000 ($20,000 of Y Country bonds and $40,000 of C Corporation stock).

(iii) Income of A Corporation for 1963 consists of the following amounts, after taking into account deductions allowable under paragraph (c) of § 1.954-1:

Interest from:	
U.S. Government bonds	$250
X Country bonds	750
Y Country bonds	1,000
Total interest	2,000
Dividends from:	
B Corporation	9,000
C Corporation	19,000
Total dividends	28,000
Gain from the sale on 8-1-63 of 50 shares of stock in C Corporation:	
Amount realized	25,000
Adjusted basis	20,000
Total gain on stock	5,000
Total income after deductions	35,000

(iv) On December 31, 1963, the assets of A Corporation (determined as provided in paragraph (d) of § 1.955-2) consist of the following amounts:

Cash	$75,000
Bonds:	
U.S. Government bonds	5,000
X Country bonds	15,000
Y Country bonds	20,000
Z Country bonds (acquired 10-1-63, but held for more than 6 months before disposition)	40,000
Total bonds	80,000
Stock in foreign corporations:	
100 shares of B Corporation stock	10,000
50 shares of C Corporation stock	20,000
Total stock	30,000
Total assets	185,000

(v) Corporation C qualifies under § 1.955-5 as a less developed country corporation for 1963, but B Corporation does not qualify as a less developed country corporation for such year. Corporation A's qualified investments in less developed countries as of December 31, 1963, amount to $80,000 ($20,000 of Y Country bonds, $40,000 of Z Country bonds, and $20,000 of C Corporation stock).

(vi) Corporation A for 1963, after application of section 954(b)(1), has foreign base company income of $15,000, which amount is determined as follows:

Dividends and interest from investments which at the time of receipt are qualified investments in less developed countries (sec. 954(b)(1)(A)):	
Interest from Y Country bonds	$1,000
Dividends from C Corporation stock	19,000
Total dividends and interest	20,000
Net gain from the sale of investments which at the time of sale are qualified investments in less developed countries (sec. 954(b)(1)(B)):	
Gains	5,000
Losses	0
Net gain	5,000
Total dividends, interest, and gains	25,000
Increase for 1963 in qualified investments in less developed countries (sec. 954(f)):	
Qualified investments at 12-31-63	80,000
Qualified investments at 12-31-62	60,000
Increase for 1963	20,000
Foreign base company income for 1963 determined under sec. 954 (a) but without regard to sec. 954(b)(1)	35,000
Less: Exclusion from foreign base company income ($25,000 total dividends, interest, and gains, but not to exceed the $20,000 increase in qualified investments in less developed countries)	20,000
Foreign base company income for 1963	15,000

Example (2). (i) Assume the same facts as in example (1) and the additional facts set forth in this example, except that M Corporation properly files without consent a timely election under paragraph (b)(1) of § 1.955-3 to determine A Corporation's increase for 1963 in qualified investments in less developed countries pursuant to paragraph (b)(2) of this section. On December 31, 1964, the assets of A Corporation (determined as provided in paragraph (d) of § 1.955-2) consist of the following amounts:

Cash	$80,000
Bonds:	
U.S. Government bonds	5,000
X Country bonds	15,000
Z Country bonds	70,000
Total bonds	90,000
Stock in foreign corporations:	
100 shares of B Corporation stock	10,000
50 shares of C Corporation stock	20,000
Total stock	30,000
Total assets	200,000

(ii) For 1964, B Corporation and C Corporation each qualify under § 1.955-5 as a less developed country corporation and countries X, Y, and Z are designated as economically less developed countries. Corporation A's qualified investments in less developed countries as of December 31, 1964, amount to $115,000 ($15,000 of X Country bonds, $70,000 of Z Country bonds, $10,000 of B Corporation stock, and $20,000 of C Corporation stock). By reason of paragraph (c) of this section, A Corporation's qualified investments in less developed countries as of December 31, 1962, amount to $75,000 ($15,000 of X Country bonds, $20,000 of Y Country bonds, and $40,000 of C Corporation stock).

(iii) Corporation A for 1963, after application of section 954(b)(1), has foreign base company income of $9,250, which amount is determined as follows:

Dividends and interest from investments which at the time of receipt are qualified investments in less developed countries (sec. 954(b)(1)(A):	
Interest from X Country bonds	$750
Interest from Y Country bonds	1,000
Dividends from C Corporation stock	19,000
Total dividends and interest	20,750
Net gain from the sale of investments which at the time of sale are qualified investments in less developed countries (sec. 954(b)(1)(B)):	
Gains	5,000
Losses	0
Net gain	5,000
Total dividends, interest, and gains	25,750
Increase for 1963 in qualified investments in less developed countries (sec. 955(b)(3)):	
Qualified investments at 12-31-64	115,000
Qualified investments at 12-31-62	75,000
Increase for 1963	40,000
Foreign base company income for 1963 determined under sec. 954(a) but without regard to sec. 954(b)(1)	35,000
Less: Exclusion from foreign base company income ($25,750 total dividends, interest, and gains, but not to exceed the $40,000 increase in qualified investments in less developed countries)	25,750
Foreign base company income for 1963	9,250

[T.D. 6734, 29 FR 6400, May 15, 1964]

§ 1.955–1 Shareholder's pro rata share of amount of previously excluded subpart F income withdrawn from investment in less developed countries.

(a) *In general.* Section 955 provides rules for determining the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries. Pursuant to section 951(a)(1)(A)(ii) and the regulations thereunder, a United States shareholder of such controlled foreign corporation must include in his gross income his pro rata share of such amount as determined in accordance with paragraph (c) of this section.

(b) *Amount withdrawn by controlled foreign corporation*—(1) *In general.* For purposes of sections 951 through 964, the amount of a controlled foreign corporation's previously excluded subpart F income which is withdrawn for any taxable year from investment in less developed countries is an amount equal to the decrease for such year in such corporation's qualified investments in less developed countries. Such decrease is, except as provided in § 1.955-3—

(i) An amount equal to the excess of the amount of its qualified investments in less developed countries at the close of the preceding taxable year over the amount of its qualified investments in less developed countries at the close of the taxable year, minus

(ii) The amount (if any) by which recognized losses on sales or exchanges by such corporation during the taxable year of qualified investments in less developed countries exceed its recognized gains on sales or exchanges during such year of qualified investments in less developed countries,

but only to the extent that the net amount so determined does not exceed the limitation determined under subparagraph (2) of this paragraph. See § 1.955-2 for determining the amount of qualified investments in less developed countries.

(2) *Limitations applicable in determining decreases*—(i) *General.* The limitation referred to in subparagraph (1) of this paragraph for any taxable year of a controlled foreign corporation shall be the lesser of the following two limitations:

(*a*) The sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, or,

(*b*) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954-1 from the foreign base company income of such corporation for all prior taxable years, minus the sum of the amounts (determined under this paragraph) of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i)(*a*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(*a*) Amounts which are, or have been, included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) (other than an amount, included in gross income of a United States shareholder under section 951(a)(1)(A)(ii) or section 951(a)(1)(B) for the taxable year) and have not been distributed, or

(*b*) (*1*) Amounts which, for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a controlled foreign corporation's decrease in qualified investments in less developed countries. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(c) *Shareholder's pro rata share of amount withdrawn by controlled foreign corporation*—(1) *In general.* A United States shareholder's pro rata share of a controlled foreign corporation's previously excluded subpart F income withdrawn for any taxable year from investment in less developed countries is his pro rata share of the amount withdrawn for such year by such corporation, as determined under paragraph (b) of this section. See section 955(a)(3).

(2) *Special rule.* A United States shareholder's pro rata share of the net amount determined under paragraph (b)(2)(i)(*b*) of this section with respect to any stock of the controlled foreign corporation owned by such shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing treatment of gain from sales or exchanges of stock in certain foreign corporations.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). A, a United States shareholder, owns 60 percent of the only class of stock of M Corporation, a controlled foreign corporation throughout the entire period here involved. Both A and M Corporation use the calendar year as a taxable year. Corporation M's qualified investments in less developed countries at the close of 1964 amount to $125,000; and, at the close of 1965, to $75,000. During 1965, M Corporation realizes recognized gains of $5,000 and recognized losses of $15,000, on sales of qualified investments in less developed countries. Corporation M's earnings and profits for 1965 and its accumulated earnings and profits for 1963 and 1964 amount to $45,000, as determined under paragraph (b)(2) of this section. The amount excluded under section 954(b)(1) for 1963 from its foreign base company income is $75,000, and the amount of its previously excluded subpart F income withdrawn for 1964 from investment in less developed countries is $25,000. The amount of M Corporation's previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $40,000, and A's pro rata share of such amount is $24,000, determined as follows:

(i) Qualified investments in less developed countries at the close of 1964	$125,000
(ii) Less: Qualified investments in less developed countries at the close of 1965	75,000
(iii) Balance	50,000
(iv) Less: Excess of recognized losses over recognized gains on sales during 1965 of qualified investments in less developed countries ($15,000 less $5,000)	10,000
(v) Tentative decrease in qualified investments in less developed countries for 1965	40,000
(vi) Earnings and profits for 1963, 1964, and 1965	45,000
(vii) Excess of amount excluded under sec. 954(b)(1) from foreign base company income for 1963 ($75,000 over amount of previously excluded subpart F income withdrawn for 1964 from investment in less developed countries ($25,000)	50,000
(viii) M Corporation's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries (item (v), but not to exceed the lesser of item (vi) or item (vii))	40,000
(ix) A's pro rata share of M Corporation's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries (60 percent of $40,000)	$24,000

Example (2). The facts are the same as in example (1), except that M Corporation's earnings and profits (determined under paragraph (b)(2) of this section) for 1963, 1964, and 1965 (item (vi)) are $30,000 instead of $45,000. Corporation M's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $30,000. A's pro rata share of such amount is $18,000 (60 percent of $30,000).

Example (3). The facts are the same as in example (1), except that the excess of the amount excluded under section 954(b)(1) for 1963 from M Corporation's foreign base company income over the amount of its previously excluded subpart F income withdrawn for 1964 from investment in less developed countries (item (vii)) is $20,000 instead of $50,000. Corporation M's amount of previously excluded subpart F income withdrawn for 1965 from investment in less developed countries is $20,000. A's pro rata share of such amount is $12,000 (60 percent of $20,000).

[T.D. 6683, 28 FR 11178, Oct. 18, 1963, as amended by T.D. 6795, 30 FR 942, Jan. 29, 1965]

§ 1.955-2 Amount of a controlled foreign corporation's qualified investments in less developed countries.

(a) *Included property.* For purposes of sections 951 through 964, a controlled foreign corporation's "qualified investments in less developed countries" are items of property (other than property excluded under paragraph (b)(1) of this section) owned directly by such corporation on the applicable determination date for purposes of section 954(f) or section 955(a)(2) and consisting of one or more of the following:

(1) Stock of a less developed country corporation if the controlled foreign corporation owns (within the meaning of paragraph (b)(2) of this section) on the applicable determination date 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation;

(2) An obligation (as defined in paragraph (b)(3) of this section) of a less developed country corporation which, at the time of acquisition (as defined in paragraph (b)(4) of this section) of such obligation by the controlled foreign corporation, has a maturity of one year or more, but only if the controlled foreign corporation owns (within the meaning of paragraph (b)(2) of this section) on the applicable determination date 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; and

(3) An obligation (as defined in paragraph (b)(3) of this section) of a less developed country, including obligations issued or guaranteed by the government of such country or of a political subdivision thereof and obligations of any agency or instrumentality of such country, in which such country is

financially committed. The application of this subparagraph may be illustrated by the following example:

Example. A, a political subdivision of foreign country X, constructs and operates a toll bridge. Country X is a less developed country throughout the period here involved. A issues bonds under an indenture which provides for amortization of the principal and interest of such bonds only out of the net revenues derived from operation of the bridge. The bonds of A are obligations in which X country is financially committed and, in the hands of a controlled foreign corporation, are qualified investments in less developed countries.

(b) *Special rules*—(1) *Excluded property.* For purposes of paragraph (a) of this section, property which is disposed of within 6 months after the date of its acquisition shall be excluded from a controlled foreign corporation's qualified investments in less developed countries. However, the fact that property acquired by a controlled foreign corporation has not been held on an applicable determination date for more than 6 months after the date of its acquisition shall not prevent such property from being included in the controlled foreign corporation's qualified investments in less developed countries on such date. Proper adjustments shall be made subsequently, however, to exclude any item of property so included, if the property is in fact disposed of within 6 months after the date of its acquisition. See section 955(b)(4).

(2) *Determination of stock ownership.* In determining for purposes of paragraph (a) (1) and (2) of this section whether a controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of a less developed country corporation, only stock owned directly by such controlled foreign corporation shall be taken into account and the provisions of section 958 and the regulations thereunder shall not apply. See section 958(a)(1).

(3) *Obligation defined.* For purposes of paragraph (a)(2) and (3) of this section, the term "obligation" means any bond, note, debenture, certificate, or other evidence of indebtedness. In the absence of legal, governmental, or business reasons to the contrary, the indebtedness must bear interest or be issued at a discount.

(4) *Date of acquisition.* For purposes of paragraph (a)(2) of this section, an obligation shall be considered acquired by a foreign corporation as of the date such corporation acquires an adjusted basis in the obligation. For this purpose, in a case in which a foreign corporation acquires an obligation in a transaction (other than a reorganization of the type described in section 368(a)(1) (E) or (F)) in which no gain or loss would be recognized had the transaction been between two domestic corporations, such corporation will be considered to have acquired an adjusted basis in such obligation as of the date such transaction occurs.

(c) *Termination of designation as a less developed country.* For purposes of sections 951 through 964, property which would constitute a qualified investment in a less developed country but for the fact that a foreign country or United States possession has, after the acquisition of such property by the controlled foreign corporation, ceased to be a less developed country shall be treated as a qualified investment in a less developed country. The application of this paragraph may be illustrated by the following example:

Example. On December 31, 1969, in accordance with the provisions of § 1.955-4, the designation of the foreign country X as an economically less developed country is terminated. Corporation M, a controlled foreign corporation, has $50,000 of qualified investments in country X acquired before December 31, 1969. After 1969 such investments are treated as qualified investments in a less developed country notwithstanding the termination of the status of X Country as an economically less developed country. However, if such qualified investments of M Corporation are reduced to $40,000, each United States shareholder of M Corporation is required, subject to the provisions of § 1.955-1, to include his pro rata share of the $10,000 decrease in his gross income under section 951(a)(1)(A)(ii) and the regulations thereunder.

(d) *Amount attributable to property*—(1) *General rule.* For purposes of this section, the amount taken into account with respect to any property which constitutes a qualified investment in a less developed country shall be its adjusted basis as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (2) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's qualified investments in less developed countries will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954–1.

(3) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes a qualified investment in a less developed country on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

[T.D. 6683, 28 FR 11179, Oct. 18, 1963]

§ 1.955–3 Election as to date of determining qualified investments in less developed countries.

(a) *Nature of election.* In lieu of determining the increase under the provisions of section 954(f) and paragraph (a) of § 1.954–5, or the decrease under the provisions of section 955(a)(2) and paragraph (b) of § 1.955–1, in a controlled foreign corporation's qualified investments in less developed countries for a taxable year in the manner provided in such provisions, a United States shareholder of such controlled foreign corporation may elect, under the provisions of section 955(b)(3) and this section, to determine such increase in accordance with the provisions of paragraph (b) of § 1.954–5 and to determine such decrease by ascertaining the amount by which—

(1) Such controlled foreign corporation's qualified investments in less developed countries at the close of such taxable year exceed its qualified investments in less developed countries at the close of the taxable year immediately following such taxable year, and reducing such excess by

(2) The amount determined under paragraph (b)(1)(ii) of § 1.955–1 for such taxable year,

subject to the limitation provided in paragraph (b)(2) of § 1.955–1 for such taxable year. An election under this section may be made with respect to each controlled foreign corporation with respect to which a person is a United States shareholder within the meaning of section 951(b), but the election may not be exercised separately with respect to the increases and the decreases of such controlled foreign corporation. If an election is made under this section to determine the increase of a controlled foreign corporation in accordance with the provisions of paragraph (b) of § 1.954–5, subsequent decreases of such controlled foreign corporation shall be determined in accordance with this paragraph and not in accordance with paragraph (b) of § 1.955–1.

(b) *Time and manner of making election*—(1) *Without consent.* An election under this section with respect to a controlled foreign corporation shall be made without the consent of the Commissioner by a United States shareholder's filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such controlled foreign corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such controlled foreign corporation, and

(ii) Such controlled foreign corporation realizes foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954-1.

The statement shall contain the name and address of the controlled foreign corporation and identification of such first taxable year of such corporation.

(2) *With consent.* An election under this section with respect to a controlled foreign corporation may be made by a United States shareholder at any time with the consent of the Commissioner. Consent will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute an amount described in section 954(b)(1) in accordance with the election provided in this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The first taxable year of the controlled foreign corporation for which income is to be computed under the election;

(iv) The amount of the controlled foreign corporation's qualified investments in less developed countries at the close of its preceding taxable year; and

(v) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954-1 from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years during which such shareholder was a United States shareholder of such corporation.

(c) *Effect of election*—(1) *General.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election under this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and shall apply to all qualified investments in less developed countries acquired, or disposed of, by such controlled foreign corporation during the taxable year following its taxable year for which income is first computed under the election and during all succeeding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's qualified investments in less developed countries for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of the controlled foreign corporation's qualified investments in less developed countries at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the United States shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of tax of such United States shareholder for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination

shall be paid by the United States shareholder upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the United States shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation.* Upon application by the United States shareholder, the election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected. Unless such agreement provides otherwise, the change in the controlled foreign corporation's qualified investments in less developed countries for its first taxable year for which income is computed without regard to the election previously made will be considered to be zero for purposes of effectuating the revocation. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to compute the amounts described in section 954(b)(1) or 955(a) without regard to the election provided in this section. The application shall include the following information:

(i) The name and address of the United States shareholder;

(ii) The name and address of the controlled foreign corporation;

(iii) The taxable year of the controlled foreign corporation for which such amounts are to be so computed;

(iv) The amount of the controlled foreign corporation's qualified investments in less developed countries at the close of its preceding taxable year;

(v) The sum of the amounts excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954-1 from the foreign base company income of the controlled foreign corporation for all prior taxable years during which such shareholder was a United States shareholder of such corporation and the sum of the amounts of its previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years during which such shareholder was a United States shareholder of such corporation; and

(vi) The reasons for the request for consent to revocation.

(4) *Transfer of stock.* If during any taxable year of a controlled foreign corporation—

(i) A United States shareholder who has made an election under this section with respect to such controlled foreign corporation sells, exchanges, or otherwise disposes of all or part of his stock in such controlled foreign corporation, and

(ii) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the controlled foreign corporation's acquisitions and dispositions of qualified investments in less developed countries for such taxable year shall be considered to be zero. If the United States shareholder's successor in interest is entitled to and does make an election under paragraph (b)(1) of this section to determine the controlled foreign corporation's increase in qualified investments in less developed countries for the taxable year in which he acquires such stock, such increase with respect to the stock so acquired shall be determined in accordance with the provisions of paragraph (b)(1) of § 1.954-5. If the controlled foreign corporation realizes no foreign base company income from which amounts are excluded under section 954(b)(1) and paragraph (b)(1) of § 1.954-1 for the taxable year in which the United States shareholder's successor in interest acquires such stock and such successor in interest makes an election under paragraph (b)(1) of this section with respect to a subsequent taxable year of such controlled foreign corporation, the increase in the controlled foreign corporation's qualified investments in less developed countries for such subsequent taxable year shall be determined in accordance with the provisions of paragraph (b)(2) of § 1.954-5.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as a taxable year. In a statement filed with its return for 1963, M Corporation makes an election under section 955(b)(3) and the election remains in force for the taxable year 1964. At December 31, 1964, A Corporation's qualified investments in less developed countries amount to $100,000; and, at December 31, 1965, to $80,000. For purposes of paragraph (a) (1) of this section, A Corporation's decrease in qualified investments in less developed countries for the taxable year 1964 is $20,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in less developed countries at December 31, 1964 ($100,000) exceed its qualified investments in less developed countries at December 31, 1965 ($80,000).

Example (2). The facts are the same as in example (1) except that A Corporation experiences no changes in qualified investments in less developed countries during its taxable years 1966 and 1967. If M Corporation's election were to remain in force, A Corporation's acquisitions and dispositions of qualified investments in less developed countries during A Corporation's taxable year 1968 would be taken into account in determining whether A Corporation has experienced an increase or a decrease in qualified investments in less developed countries for its taxable year 1967. However, M Corporation duly files before the close of A Corporation's taxable year 1967 an application for consent to revocation of M Corporation's election under section 955(b)(3), and, pursuant to an agreement between the Commissioner and M Corporation, consent is granted by the Commissioner. Assuming such agreement does not provide otherwise, A Corporation's change in qualified investments in less developed countries for its taxable year 1967 is zero because the effect of the revocation of the election is to treat acquisitions and dispositions of qualified investments in less developed countries actually occurring in 1968 as having occurred in such year rather than in 1967.

Example (3). The facts are the same as in example (2) except that A Corporation's qualified investments in less developed countries at December 31, 1968, amount to $70,000. For purposes of paragraph (b)(1)(i) of § 1.955-1, the decrease in A Corporation's qualified investments in less developed countries for the taxable year 1968 is $10,000 and is determined by ascertaining the amount by which A Corporation's qualified investments in less developed countries at December 31, 1967 ($80,000) exceed its qualified investments in less developed countries at December 31, 1968 ($70,000).

Example (4). The facts are the same as in example (1) except that on September 30, 1965, M Corporation sells 40 percent of the only class of stock of A Corporation to N Corporation, a domestic corporation. Corporation N uses the calendar year as a taxable year. Corporation A remains a controlled foreign corporation immediately after such sale of its stock. Corporation A's qualified investments in less developed countries at December 31, 1966, amount to $90,000. The changes in A Corporation's qualified investments in less developed countries occurring in its taxable year 1965 are considered to be zero with respect to the 40-percent stock interest acquired by N Corporation. The entire $20,000 reduction in A Corporation's qualified investments in less developed countries which occurs during the taxable year 1965 is taken into account by M Corporation for purposes of paragraph (a)(1) of this section in determining its tax liability for the taxable year 1964. Corporation A's increase in qualified investments in less developed countries for the taxable year 1965 with respect to the 60-percent stock interest retained by M Corporation is $6,000 and is determined by ascertaining M Corporation's pro rata share (60 percent) of the amount by which A Corporation's qualified investments in less developed countries at December 31, 1968 ($90,000) exceed its qualified investments in less developed countries at December 31, 1965 ($80,000). Corporation N does not make an election under section 955(b)(3) in its return for its taxable year 1966. Corporation A's increase in qualified investments in less developed countries for the taxable year 1966 with respect to the 40-percent stock interest acquired by N Corporation is $4,000.

[T.D. 6683, 28 FR 11180, Oct. 18, 1963]

§ 1.955-4 Definition of less developed country.

(a) *Designation by Executive order.* For purposes of sections 951 through 964, the term "less developed country" means any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States with respect to which, on the first day of the foreign corporation's taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of such sections. Each territory, department, province, or possession of any foreign country other than a country within the Sino-Soviet bloc may be treated as a separate foreign country for purposes of such designation if the territory, department, province, or possession is overseas from the country of which it is a territory, department, province, or possession. Thus, for example, an overseas possession of a foreign country may be designated by Executive order as an economically less developed country even though the foreign country itself has not been designated as an economically less developed country; or the foreign country may be so designated even though the overseas possessions of such country have not been designated as economically less developed countries. The term "possession of the United States", for purposes of section 955(c)(3) and this section, shall be construed to have the same meaning as that contained in paragraph (b)(2) of § 1.957-3.

(b) *Countries not eligible for designation.* Section 955(c)(3) provides that no designation by Executive order may be made under section 955(c)(3) and paragraph (a) of this section with respect to—

Australia, Austria, Belgium, Canada, Denmark, France, Germany (Federal Republic), Hong Kong, Italy, Japan, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Union of South Africa, San Marino, Sweden, Switzerland, United Kingdom.

(c) *Termination of designation.* Section 955(c)(3) provides that, after the President has designated any foreign country or possession of the United States as an economically less developed country for purposes of sections 951 through 964, he may not terminate such designation (either by issuing an Executive order for the purpose of terminating such designation or by issuing an Executive order which has the effect of terminating such designation) unless, at least 30 days prior to such termination, he has notified the Senate and the House of Representatives of his intention to terminate such designation. If such 30-day notice is given, no action by the Congress of the United States is necessary to effectuate the termination. The requirement for giving 30-day notice to the Senate and House of Representatives applies also to the termination of a designation with respect to an overseas territory, department, province, or possession of a foreign country. See paragraph (c) of § 1.955-2 for the effect of a termination of a Presidential designation upon property which would be a qualified investment in a less developed country but for the fact of such termination.

[T.D. 6683, 28 FR 11182, Oct. 18, 1963]

§ 1.955-5 Definition of less developed country corporation.

(a) *Less developed country corporation*—(1) *In general.* For purposes of sections 951 through 964, the term "less developed country corporation" means a foreign corporation described in paragraph (b) of this section and also any foreign corporation—

(i) Which is engaged in the active conduct of one or more trades or businesses during the entire taxable year;

(ii) Which derives 80 percent or more of its gross income, if any, for such taxable year from sources within less developed countries, as determined under the provisions of § 1.955-6; and

(iii) Which has 80 percent or more in value (within the meaning of paragraph (d) of this section) of its assets on each day of such taxable year consisting of one or more of the following items of property:

(*a*) Property (other than property described in (*b*) through (*h*) of this subdivision) which is used, or held for use, in such trades or businesses and is located in one or more less developed countries;

(*b*) Money;

(*c*) Deposits with persons carrying on the banking business;

(*d*) Stock of any other less developed country corporation;

(*e*) Obligations (within the meaning of paragraph (b)(3) of § 1.955-2) of another less developed country corporation which at the time of their acquisition (within the meaning of paragraph (b)(4) of § 1.955-2) by the foreign corporation have a maturity of one year or more;

(*f*) Obligations (within the meaning of paragraph (b)(3) of § 1.955-2) of any less developed country;

(*g*) Investments which are required to be made or held because of restrictions imposed by the government of any less developed country; and

(*h*) Property described in section 956(b)(2).

For purposes of this subparagraph, if a foreign corporation is a partner in a foreign partnership, as defined in section 7701(a) (2) and (5) and the regulations thereunder, such corporation will be considered to be engaged in the active conduct of a trade or business to the extent and in the manner in which the partnership is so engaged and to own directly its proportionate share of each of the assets of the partnership. For purposes of subdivision (i) of this subparagraph, a newly-organized foreign corporation will be considered engaged in the active conduct of a trade or business from the date of its organization if such corporation commences business operations as soon as practicable after such organization. In the absence of affirmative evidence showing that the 80-percent requirement of subdivision (iii) of this subparagraph has not been satisfied on each day of the taxable year, such requirement will be considered satisfied if it is established to the satisfaction of the district director that such requirement has been satisfied on the last day of each quarter of the taxable year of the foreign corporation. For purposes of subdivision (iii) of this subparagraph, property (other than stock in trade or other property of a kind which would properly be included in inventory of the foreign corporation if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the trade or business of the foreign corporation) purchased for use in a trade or business and temporarily located outside less developed countries will be considered located in less developed countries if, but only if, such property is shipped to and received in less developed countries promptly after such purchase.

(2) *Special rules.* For purposes of subparagraph (1)(iii)(*a*) of this paragraph—

(i) *Treatment of receivables.* Bills receivable, accounts receivable, notes receivable and open accounts shall be considered to be used in the trade or business and located in less developed countries if, but only if—

(*a*) Such obligations arise out of the rental of property located in less developed countries, the performance of services within less developed countries, or the sale of property manufactured, produced, grown, or extracted in less developed countries, but only to the extent that the aggregate amount of such obligations at any time during the taxable year does not exceed an amount which is ordinary and necessary to carry on the business of both parties to the transactions if such transactions are between unrelated persons or, if such transactions are between related persons, an amount which would be ordinary and necessary to carry on the business of both parties to the transactions if such transactions were between unrelated persons;

(*b*) In the case of bills receivable, accounts receivable, notes receivable, and open accounts arising out of transactions other than those referred to in (*a*) of this subdivision—

(*1*) If the obligor is an individual such individual is a resident of one or more less developed countries and of no other country which is not a less developed country;

(*2*) If the obligor is a corporation which as to the foreign corporation is a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954-1, such obligor meets, with respect to the period ending with the close of its annual accounting period in which occurs the date on which the obligation is incurred, the 80-percent gross income requirement of paragraph (b)(1)(ii) of § 1.955-6.

(*3*) If the obligor is a corporation which as to the foreign corporation is not a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954-1, it is reasonable, on the basis of ascertainable facts, for the obligee to believe that the obligor meets, with respect to such period, the 80-percent gross income requirement of paragraph (b)(1)(ii) of § 1.955–6.

(ii) *Location of interests in real estate.* Interests in real estate such as leaseholds of land or improvements thereon, mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and mineral, oil, or gas interests shall be considered located in less developed countries if, but only if, the underlying real estate is located in less developed countries.

(iii) *Location of certain other intangibles.* Intangible property (other than any such property described in subdivision (i) or (ii) of this subparagraph) used in the trade or business of the foreign corporation shall be considered to be located in less developed countries in the same ratio that the amount of the foreign corporation's tangible property and property described in subdivision (i) or (ii) of this subparagraph used in its trades or businesses and located or deemed located in less developed countries bears to the total amount of its tangible property and property described in subdivision (i) or (ii) of this subparagraph used in its trades or businesses.

(3) *Illustration.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Foreign corporation A is formed on November 1, 1963, to engage in the business of manufacturing and selling radios in Brazil, a less developed country as of November 1, 1963. Corporation A uses the calendar year as a taxable year. Shortly after it is formed, A Corporation acquires a plant site and begins construction of a plant which is completed on August 1, 1964. Corporation A commences business operations as soon as practicable and continues such operations through December 31, 1964, and thereafter. Corporation A will be considered for purposes of subparagraph (1)(i) of this paragraph to be engaged in the active conduct of a trade or business for its entire taxable years ending on December 31, 1963, and 1964. The plant site and the plant (while under construction and after completion) will be considered to be property held during such taxable years for use in A Corporation's trade or business.

(b) *Shipping companies.* For purposes of sections 951 through 964, the term "less developed country corporation" also means any foreign corporation—

(1) Which has 80 percent or more of its gross income, if any, for the taxable year consisting of one or more of—

(i) Gross income derived—

(*a*) From, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country,

(*b*) From, or in connection with, the performance of services directly related to the use in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or

(*c*) From the sale or exchange of aircraft or vessels registered under the laws of a less developed country and used in foreign commerce by such foreign corporation;

(ii) Dividends and interest received or accrued from other foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which is owned at the time such dividends and interest are so received or accrued by such foreign corporation; and

(iii) Gain from the sale or exchange of stock or obligations of other foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which is owned by such foreign corporation immediately before such sale or exchange; and

(2) Which has 80 percent or more in value (within the meaning of paragraph (d) of this section) of its assets on each day of the taxable year consisting of—

(i) Assets used, or held for use, for the production of income described in subparagraph (1) of this paragraph, or in connection with the production of such income, whether or not such income is received during the taxable year, and

(ii) Property described in section 956(b)(2).

In the absence of affirmative evidence showing that the 80-percent requirement of this subparagraph has not been satisfied on each day of the taxable year such requirement will be considered satisfied if it is established to the satisfaction of the district director that such requirement has been satisfied on the last day of each quarter of the taxable year of the foreign corporation. The provisions of this subparagraph may be illustrated by the following example:

Example. Foreign corporation A is formed on November 1, 1963, for the purpose of constructing and operating a vessel and, on that date, enters a charter agreement which provides that such vessel will be registered under the laws of Liberia, a less developed country as of November 1, 1963, and operated between South American and European ports. Corporation A uses the calendar year as a taxable year. Construction of the vessel is completed on September 1, 1965, and the vessel is registered under the laws of Liberia and operated between South American and European ports through December 31, 1965, and thereafter. The charter and the vessel (while under construction and after completion), or any interest of A Corporation in such assets, will be considered assets which are held by A Corporation during its taxable years ending on December 31, 1963, 1964, and 1965, for use in the production of income described in subparagraph (1) of this paragraph.

(c) *Determination of stock ownership.* In determining for purposes of paragraph (b)(1) (ii) and (iii) of this section whether a foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of a less developed country corporation, only stock owned directly by such foreign corporation shall be taken into account and the provisions of section 958 and the regulations thereunder shall not apply. See section 958(a)(1).

(d) *Determination of value.* For purposes of paragraphs (a)(1)(iii) and (b)(2) of this section—

(1) *General.* Except as provided in subparagraph (2) of this paragraph, the value at which property shall be taken into account is its actual value (not reduced by liabilities) which, in the absence of affirmative evidence to the contrary, shall be deemed to be its adjusted basis.

(2) *Treatment of certain receivables.* The value at which receivables described in paragraph (a)(2)(i) of this section and held by a foreign corporation using the cash receipts and disbursements method of accounting shall be taken into account is their actual value (not reduced by liabilities) which, in the absence of affirmative evidence to the contrary, shall be deemed to be their face value.

[T.D. 6683, 28 FR 11182, Oct. 18, 1963]

§ 1.955-6 Gross income from sources within less developed countries.

(a) *General.* For purposes of paragraph (a)(1)(ii) of § 1.955.5, the determination whether a foreign corporation has derived 80 percent or more of its gross income from sources within less developed countries for any taxable year shall be made by the application of the provisions of sections 861 through 864, and §§ 1.861-1 through 1.863-5, in application of which the name of a less developed country shall be substituted for "the United States", except that if income is derived by the foreign corporation from—

(1) Interest (other than interest to which subparagraph (3) of this paragraph applies), the rules set forth in paragraph (b) of this section shall apply;

(2) Dividends, the rules set forth in paragraph (c) of this section shall apply or;

(3) Income (including interest) derived in connection with the sale of tangible personal property, the rules set forth in paragraph (d) of this section shall apply.

The source of income described in subparagraphs (1), (2), or (3) of this paragraph shall be determined solely under the rules of this section and without regard to the rules of sections 861 through 864, and the regulations thereunder.

(b) *Interest*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and paragraph (d) of this section, gross income derived by the foreign corporation from interest on any indebtedness—

(i) Of an individual shall be treated as income from sources within a less developed country if, but only if, such individual is a resident of one or more less developed countries and of no other country which is not a less developed country.

(ii) Of a corporation shall be treated as income from sources within less developed countries if, but only if, 80 percent or more of the gross income of the payer corporation for the 3-year period ending with the close of its annual accounting period in which such interest is paid, or for such part of such 3-year period as such corporation has been in existence, or for such part of such 3-year period as occurs on and after the beginning of such corporation's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within less developed countries as determined in accordance with the principles of this section; or

(iii) Of a less developed country, including obligations issued or guaranteed by the government of such country or of a political subdivision thereof and obligations of any agency or instrumentality of such country, in which such country is financially committed shall be treated as income from sources within such country.

(2) *Special rule.* Gross income derived by the foreign corporation from interest on obligations of the United States shall be treated as income from sources within less developed countries without regard to the provisions of subparagraph (1) of this paragraph.

(3) *Payers other than related persons.* For purposes of subparagraph (1)(ii) of this paragraph, a payer corporation which as to the recipient corporation is not a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954-1 shall be deemed to have satisfied the 80-percent gross income requirement if, on the basis of ascertainable facts, it is reasonable for the recipient corporation to believe that such requirement is satisfied.

(c) *Dividends*—(1) *In general.* Gross income derived by the foreign corporation from dividends, as defined in section 316 and the regulations thereunder, shall be treated as income from sources within less developed countries if, but only if, 80 percent or more of the gross income of the payer corporation for the 3-year period ending with the close of its annual accounting period in which such dividends are distributed, or for such part of such 3-year period as such corporation has been in existence, or for such part of such 3-year period as occurs on and after the beginning of such cor- poration's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within less developed countries as determined in accordance with the principles of this section.

(2) *Payers other than related persons.* See paragraph (b)(3) of this section for rule governing satisfaction of the 80-percent gross income requirement by payers other than related persons.

(d) *Sale of tangible personal property*—(1) *In general.* Income (whether in the form of profits, commissions, fees, interest, or otherwise) derived by the foreign corporation in connection with the sale of tangible personal property shall be treated as income from sources within less developed countries if, but only if—

(i) Such property is produced (within the meaning of subparagraph (2) of this paragraph) within less developed countries; or

(ii) Such property is sold for use, consumption, or disposition within less developed countries even though produced outside less developed countries and the selling corporation is engaged within less developed countries, in connection with sales of such property, in continuous operational activities which are substantial in relation to such sales, as evidenced, for example, by the maintenance within less developed countries of a substantial sales or service organization or substantial facilities for the storage, handling, transportation, assembly, packaging, or servicing of such property.

(2) *Production defined.* For purposes of this paragraph, the term "produced" means manufactured, grown, extracted, or constructed and includes a substantial transformation of property purchased for resale or the manufacture of a product when purchased components constitute part of the property which is sold. See paragraph (a)(4) (ii) and (iii) of § 1.954-3 for a statement and illustration of the prin-

ciples set forth in the preceding sentence.

[T.D. 6683, 28 FR 11183, Oct. 18, 1963, as amended by T.D. 6688, 28 FR 11632, Oct. 31, 1963]

§ 1.956-1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(a) *In general.* Section 956(a)(1) and paragraph (b) of this section provide rules for determining the amount of a controlled foreign corporation's earnings invested in United States property at the close of any taxable year. Such amount is the aggregate amount invested in United States property to the extent such amount would have constituted a dividend if it had been distributed on such date. Subject to the provisions of section 951(a)(4) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in his gross income his pro rata share, as determined in accordance with paragraph (c) of this section, of the controlled foreign corporation's increase for any taxable year in earnings invested in United States property but only to the extent such share is not excludable from his gross income under the provisions of section 959(a)(2) and the regulations thereunder.

(b) *Amount of a controlled foreign corporation's investment of earnings in United States property*—(1) *Dividend limitation.* The amount of a controlled foreign corporation's earnings invested at the close of its taxable year in United States property is the aggregate amount of such property held, directly or indirectly, by such corporation at the close of its taxable year to the extent such amount would have constituted a dividend under section 316 and §§ 1.316-1 and 1.316-2 (determined after the application of section 955(a)) if it had been distributed on such closing day. For purposes of this subparagraph, the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) and the regulations thereunder.

(2) *Aggregate amount of United States property.* For purposes of determining an increase in earnings invested in United States property for any taxable year beginning after December 31, 1975, the aggregate amount of United States property held by a controlled foreign corporation at the close of—

(i) Any taxable year beginning after December 31, 1975, and

(ii) The last taxable year beginning before January 1, 1976 does not include stock or obligations of a domestic corporation described in section 956(b)(2)(F) or movable property described in section 956(b)(2)(G).

(3) *Treatment of earnings and profits.* For purposes of making the determination under subparagraph (1) of this paragraph as to whether an amount of investment would have constituted a dividend if distributed at the close of any taxable year of a controlled foreign corporation, earnings and profits of the controlled foreign corporation shall be considered not to include any amounts which are attributable to—

(i) Amounts which have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2)) and have not been distributed, or

(ii) (*a*) Amounts which are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*b*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subparagraph apply only in determining the limitation on a controlled foreign corporation's increase in earnings invested in United States property. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(4) *Treatment of certain investments of earnings in United States property.* For purposes of subparagraph (1) of this paragraph, a controlled foreign corporation will be considered to hold indirectly the investments in United States property held on its behalf by a trustee or a nominee or by any other foreign corporation which is created or availed of by the controlled foreign corporation principally for the purpose of holding United States property, if such other foreign corporation is controlled by the controlled foreign corporation.

(c) *Shareholder's pro rata share of increase*—(1) *General rule.* A United States shareholder's pro rata share of a controlled foreign corporation's increase for any taxable year in earnings invested in United States property is the amount determined by subtracting the shareholder's pro rata share of—

(i) The controlled foreign corporation's earnings invested in United States property at the close of its preceding taxable year, as determined under paragraph (b) of this section, reduced by amounts paid by such corporation during such preceding taxable year to which section 959(c)(1) and the regulations thereunder apply, from his pro rata share of

(ii) The controlled foreign corporation's earnings invested in United States property at the close of its current taxable year, as determined under paragraph (b) of this section.

(2) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example (1). A is a United States shareholder and direct owner of 60 percent of the only class of stock of R Corporation, a controlled foreign corporation during the entire period here involved. Both A and R Corporation use the calendar year as a taxable year. Corporation R's aggregate investment in United States property on December 31, 1964, which would constitute a dividend (as determined under paragraph (b) of this section) if distributed on such date is $150,000. During the taxable year 1964, R Corporation distributed $50,000 to which section 959(c)(1) applies. Corporation R's aggregate investment in United States property on December 31, 1965, is $250,000; and R Corporation's current and accumulated earnings and profits on such date (determined as provided in paragraph (b) of this section) are $225,000. A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property is $75,000, determined as follows:

(i) Aggregate investment in United States property on Dec. 31, 1965		$250,000
(ii) Current and accumulated earnings and profits on Dec. 31, 1965		225,000
(iii) Amount of earnings invested in United States property on Dec. 31, 1965, which would constitute a dividend if distributed on such date (lesser of item (i) or item (ii))		225,000
(iv) Aggregate investment in United States property on Dec. 31, 1964, which would constitute a dividend if distributed on such date	$150,000	
Less: Amounts distributed during 1964 to which sec. 959(c)(1) applies	50,000	100,000
(v) R Corporation's increase for 1965 in earnings invested in United States property (item (iii) minus item (iv))		125,000
(vi) A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property (item (v) times 60 percent)		75,000

Example (2). The facts are the same as in example (1), except that R Corporation's current and accumulated earnings and profits on December 31, 1965, are $100,000 instead of $225,000. Accordingly, even through R Corporation's aggregate investment in United States property on December 31, 1965, of $250,000 exceeds the net amount ($100,000) taken into account under subparagraph (1)(i) of this paragraph as of December 31, 1964, by $150,000, there is no increase for taxable year 1965 in earnings invested in United States property because of the dividend limitation of paragraph (b)(1) of this section. Corporation R's aggregate investment in United States property on December 31, 1966, is unchanged ($250,000) Corporation R's current and accumulated earnings and profits on December 31, 1966, are $175,000, and, as a consequence, its aggregate investment in United States property which would constitute a dividend if distributed on that date is $175,000. Corporation R pays no amount during 1965 to which section 959(c)(1) applies. Corporation R's increase for the taxable year 1966 in earnings invested in United States property is $75,000, and A's pro rata share of that amount is $45,000 ($75,000 times 60 percent).

(d) *Date and basis of determinations.* The determinations made under paragraph (c)(1)(i) of this section with respect to the close of the preceding taxable year of a controlled foreign corporation and under paragraph (c)(1)(ii) with respect to the close of the current taxable year of such controlled foreign corporation, for purposes of determining the United States shareholder's pro rata share of such corporation's increased investment of earnings in United States property for the current taxable year, shall be made as of the last day of the current taxable year of such corporation but on the basis of stock owned, within the meaning of section 958(a) and the regulations thereunder, by such United States shareholder on the last day of the current taxable year of the foreign corporation on which such corporation is a controlled foreign corporation. See the last sentence of section 956(a)(2). The application of this paragraph may be illustrated from the following example:

Example. Domestic corporation M owns 60 percent of the only class of stock of A Corporation, a controlled foreign corporation during the entire period here involved. Both M Corporation and A Corporation use the calendar year as a taxable year. Corporation A's investment of earnings in United States property at the close of the taxable year 1963 is $100,000, as determined under paragraph (b) of this section, and M Corporation includes its pro rata share of such amount ($60,000) in gross income for its taxable year 1963. On June 1, 1964, M Corporation acquires an additional 25 percent of A Corporation's outstanding stock from a person who is not a United States person as defined in section 957(d). Corporation A's investment of earnings in United States property at the close of the taxable year 1964, as determined under paragraph (b) of this section, is unchanged ($100,000). Corporation A pays no amount during 1963 to which section 959(c)(1) applies. Corporation M is not required, by reason of the acquisition in 1964 of A Corporation's stock, to include an additional amount in its gross income with respect to A Corporation's investment of earnings in United States property even though the earnings invested in United States property by A Corporation attributable to the stock acquired by M Corporation were not previously taxed. The determination made under paragraph (c)(1)(i) of this section as well as the determination made under paragraph (c)(1)(ii) of this section with respect to A Corporation's investment for 1964 of earnings in United States property are made on the basis of stock owned by M Corporation (85 percent) at the close of 1964.

(e) *Amount attributable to property*—(1) *General rule.* Except as provided in subparagraph (2) of this paragraph, for purposes of paragraph (b)(1) of this section the amount taken into account with respect to any United States property shall be its adjusted basis, as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (3) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) *Rule for pledges and guarantees.* For purposes of this section the amount taken into account with respect to any pledge or guarantee described in paragraph (c)(1) of § 1.956-2 shall be the unpaid principal amount on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor.

(3) *Excluded charges.* For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investment of earnings in United States property will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the fac-

tors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954 (d)(3) and paragraph (e) of § 1.954-1.

(4) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes United States property on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6704, 29 FR 2600, Feb. 20, 1964, as amended by T.D. 6795, 30 FR 942, Jan. 29, 1965; T.D. 7712, 45 FR 52374, Aug. 7, 1980]

§ 1.956-2 Definition of United States property.

(a) *Included property*—(1) *In general.* For purposes of section 956(a) and § 1.956-1, United States property is (except as provided in paragraph (b) of this section) any property acquired (within the meaning of paragraph (d)(1) of this section) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any taxable year of such foreign corporation beginning after December 31, 1962, which is—

(i) Tangible property (real or personal) located in the United States;

(ii) Stock of a domestic corporation;

(iii) An obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)); or

(iv) Any right to the use in the United States of—

(*a*) A patent or copyright,

(*b*) An invention, model, or design (whether or not patented),

(*c*) A secret formula or process, or

(*d*) Any other similar property right, which is acquired or developed by the foreign corporation for use in the United States by any person. Whether a right described in this subdivision has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use.

(2) *Illustrations.* The application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation R uses as a taxable year a fiscal year ending on June 30. Corporation R acquires on June 1, 1963, and holds on June 30, 1963, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States. Corporation R's aggregate investment in United States property at the close of its taxable year ending June 30, 1963, is zero since the property which is acquired on June 1, 1963, is not acquired during a taxable year of R Corporation beginning after December 31, 1962. Assuming no change in R Corporation's aggregate investment in United States property during its taxable year ending June 30, 1964, R Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example (2). Foreign corporation S uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable year 1965. Corporation S is not a controlled foreign corporation at any time during its taxable years 1963 and 1964. Corporation S owns on December 31, 1964, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States which it acquires during taxable years beginning after December 31, 1962. Corporation S's aggregate investment in United States property on December 31, 1964, is $100,000. Corporation S's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956-1) as of December 31, 1964, are in excess of $100,000. Assuming no change in S Corporation's aggregate investment in United States property during its taxable year 1965, S Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example (3). Foreign corporation T uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable years 1963, 1964, and 1966. At December 31, 1964, T Corporation's investment in United States property is $100,000. Corporation T is not a controlled foreign corporation at any time during its taxable year 1965 in which it acquires $25,000 of tangible property (not described in section 956(b)(2)) located in the United States. On December 31, 1965, T Corporation holds the United States property of $100,000 which it held on December 31, 1964, and, in addition, the United States property acquired in 1965. Corporation T's aggregate investment in United States property at December 31, 1965, is $125,000. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956-1) as of December 31, 1965, are in excess of $125,000, and T Corporation pays no amount during 1965 to which section 959 (c)(1) applies. Assuming no change in T Corporation's aggregate investment in United States property during its taxable year 1966, T Corporation's increase in earnings invested in United States property for such taxable year is zero.

(b) *Exceptions*—(1) *Excluded property*. For purposes of section 956(a) and paragraph (a) of this section, United States property does not include the following types of property held by a foreign corporation:

(i) Obligations of the United States.

(ii) Money.

(iii) Deposits with persons carrying on the banking business, unless the deposits serve directly or indirectly as a pledge or guarantee within the meaning of paragraph (c) of this section. See paragraph (e)(2) of § 1.956-1.

(iv) Property located in the United States which is purchased in the United States for export to, or use in, foreign countries. For purposes of this subdivision, property to be used outside the United States will be considered property to be used in a foreign country. Whether property is of a type described in this subdivision is to be determined from all the facts and circumstances in each case. Property which constitutes export trade assets within the meaning of section 971(c)(2) and paragraph (c)(3) of § 1.971-1 will be considered property of a type described in this subdivision.

(v) Any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) arising in connection with the sale or processing of property if the amount of such obligation outstanding at any time during the taxable year of the foreign corporation does not exceed an amount which is ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person, or, if the sale or processing transaction occurs between related persons, would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person if such persons were unrelated persons. Whether the amount of an obligation described in this subdivision is ordinary and necessary is to be determined from all the facts and circumstances in each case.

(vi) Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States. Whether transportation property described in this subdivision is used in foreign commerce and predominantly outside the United States is to be determined from all the facts and circumstances in each case. As a general rule, such transportation property will be considered to be used predominantly outside the United States if 70 percent or more of the miles traversed (during the taxable year at the close of which a determination is made under section 956(a)(2)) in the use of such property are traversed outside the United States or if such property is located outside the United States 70 percent of the time during such taxable year.

(vii) An amount of assets described in paragraph (a) of this section of an insurance company equivalent to the unearned premiums or reserves which are ordinary and necessary for the proper conduct of that part of its insurance business which is attributable to contracts other than those described in section 953(a)(1) and the regulations thereunder. For purposes of this subdivision, a reserve will be considered ordinary and necessary for the proper conduct of an insurance business if, under the principles of paragraph (c) of § 1.953-4, such reserve would qualify as a reserve required by law. See paragraph (d)(3) of § 1.954-2 for determining, for purposes of this subdivision, the meaning of insurance company and of unearned premiums.

(viii) For taxable years beginning after December 31, 1975, the voting or nonvoting stock or obligations of an unrelated domestic corporation. For purposes of this subdivision, an unrelated domestic corporation is a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation making the investment, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or considered as owned (within the meaning of section 958 (b)) by United States shareholders of the controlled foreign corporation making the investment. The determination of whether a domestic corporation is an unrelated corporation is made immediately after each acquisition of stock or obligations by the controlled foreign corporations.

(ix) For taxable years beginning after December 31, 1975, movable drilling rigs or barges and othet movable exploration and exploitation equipment (other than a vessel or an aircraft) which are used exclusively on the Continental Shelf (as defined in section 638) of the United States in the exploration for, development, removal or transportation of natural resources from or under ocean waters. Property of the kind described in this subdivision which is being constructed or is in storage or in transit within the United States meets the requirements of § 1.956-2(b)(1) defining excluded property if it is actually used on the Continental Shelf by the last day of the taxable year following the year of purchase, commencement of storage or commencement of transit, and has nto been used by the taxpayer anyplace else. In general, the type of property which qualifies for the exception under this subdivision includes any movable property which would be entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere pursuant to section 48(a)(2)(B) (x) (without reference to sections 49 and 50).

(x) An amount of—

(*a*) A controlled foreign cor- poration's assets described in paragraph (a) of this section equivalent to its earnings and profits which are accumulated after December 31, 1962, and are attributable to items of income described in section 952(b) and the regulations thereunder, reduced by the amount of

(*b*) The earnings and profits of such corporation which are applied in a taxable year of such corporation beginning after December 31, 1962, to discharge a liability on property, but only if the liability was in existence at the close of such corporation's taxable year immediately preceding its first taxable year beginning after December 31, 1962, and the property would have been United States property if it had been acquired by such corporation immediately before such discharge.

For purposes of this subdivision, distributions made by such corporation for any taxable year shall be considered first made out of earnings and profits for such year other than earnings and profits referred to in (*a*) of this subdivision.

(2) *Statement required.* If a United States shareholder of a controlled foreign corporation excludes any property from the United States property of such controlled foreign corporation on the ground that section 956(b)(2) applies to such excluded property, he shall attach to his return a statement setting forth, by categories described in paragraph (a)(1) of this section, the amount of United States property of the controlled foreign corporation and, by categories described in subparagraph (1) of this paragraph, the amount of such property which is excluded.

(c) *Treatment of pledges and guarantees*—(1) *General rule.* Except as provided in subparagraph (4) of this paragraph, any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) with respect to which a controlled foreign corporation is a pledgor or guarantor shall be considered for purposes of section 956(a) and paragraph (a) of this section to be United States property held by such controlled foreign corporation.

(2) *Indirect pledge or guarantee.* If the assets of a controlled foreign corporation serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for pur-

poses of paragraph (c)(1) of this section, the controlled foreign corporation will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. This paragraph (c)(2) applies only to pledges and guarantees which are made after September 8, 1980. For purposes of this paragraph (c)(2) a refinancing shall be considered as a new pledge or guarantee.

(3) *Illustrations.* The following examples illustrate the application of this paragraph (c):

Example (1). A, a United States person, borrows $100,000 from a bank in foreign country X on December 31, 1964. On the same date controlled foreign corporation R pledges its assets as security for A's performance of A's obligation to repay such loan. The place at which or manner in which A uses the money is not material. For purposes of paragraph (b) of § 1.956-1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956-1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example (2). The facts are the same as in example (1), except that R Corporation participates in the transaction, not by pledging its assets as security for A's performance of A's obligation to repay the loan, but by agreeing to buy for $1,00,000 at maturity the note representing A's obligation if A does not repay the loan. Separate arrangements are made with respect to the payment of the interest on the loan. The agreement of R Corporation to buy the note constitutes a guarantee of A's obligation. For purposes of paragraph (b) of § 1.956-1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956-1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example (3). A, a United States person, borrows $100,000 from a bank on December 10, 1981, pledging 70 percent of the stock of X, a controlled foreign corporation, as collateral for the loan. A and X use the calendar year as their taxable year. in the loan agreement, among other things, A agrees not to cause or permit X Corporation to do any of the following without the consent of the bank:

(a) Borrow money or pledge assets, except as to borrowings in the ordinary course of business of X Corporation;

(b) Guarantee, assume, or become liable on the obligation of another, or invest in or lend funds to another;

(c) Merge or consolidate with any other corporation or transfer shares of any controlled subsidiary;

(d) Sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets;

(e) Pay or secure any debt owing by X Corporation to A; and

(f) Pay any dividends, except in such amounts as may be required to make interest or principal payments on A's loan from the bank.

A retains the right to vote the stock unless a default occurs by A. Under paragraph (c)(2) of this section, the assets of X Corporation serve indirectly as security for A's performance of A's obligation to repay the loan and X Corporation will be considered a pledgor or guarantor with respect to that obligation. For purposes of paragraph (b) of § 1.956-1, X Corporation will be considered to hold A's obligation to repay the bank $100,000 and under paragraph (e)(2) of § 1.956-1, the amount taken into account in computing X Corporation's aggregate investment in United States property on December 31, 1981, is the unpaid principal amount of the obligation on that date.

(4) *Special rule for certain conduit financing arrangements.* The rule contained in subparagraph (1) of this paragraph shall not apply to a pledge or a guarantee by a controlled foreign corporation to secure the obligation of a United States person if such United States person is a mere conduit in a financing arrangement. Whether the United States person is a mere conduit in a financing arrangement will depend upon all the facts and circumstances in each case. A United States person will be considered a mere conduit in a financing arrangement in a

case in which a controlled foreign corporation pledges stock of its subsidiary corporation, which is also a controlled foreign corporation, to secure the obligation of such United States person, where the following conditions are satisfied:

(i) Such United States person is a domestic corporation which is not engaged in the active conduct of a trade or business and has no substantial assets other than those arising out of its relending of the funds borrowed by it on such obligation to the controlled foreign corporation whose stock is pledged; and

(ii) The assets of such United States person are at all times substantially offset by its obligation to the lender.

(d) *Definitions*—(1) *Meaning of "acquired"*—(i) *Applicable rules.* For purposes of this section—

(*a*) Property shall be considered acquired by a foreign corporation when such corporation acquires an adjusted basis in the property;

(*b*) Property which is an obligation of a United States person with respect to which a controlled foreign corporation is a pledgor or guarantor (within the meaning of paragraph (c) of this section) shall be considered acquired when the corporation becomes liable as a pledgor or guarantor or is otherwise considered a pledgor or guarantor (within the meaning of paragraph (c)(2) of this section); and

(*c*) Property shall not be considered acquired by a foreign corporation if—

(*1*) Such property is acquired in a transaction in which gain or loss would not be recognized under this chapter to such corporation if such corporation were a domestic corporation;

(*2*) The basis of the property acquired by the foreign corporation is the same as the basis of the property exchanged by such corporation; and

(*3*) The property exchanged by the foreign corporation was not United States property (as defined in paragraph (a)(1) of this section) but would have been such property if it had been acquired by such corporation immediately before such exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (*1*). Foreign corporation R uses the calendar year as a taxable year and acquires before January 1, 1963, stock of domestic corporation M having as to R Corporation an adjusted basis of $10,000. The stock of M Corporation is not United States property of R Corporation on December 31, 1962, since it is not acquired in a taxable year of R Corporation beginning on or after Janury 1, 1963. On June 30, 1963, R Corporation sells the M Corporation stock for $15,000 in cash and expends such amount in acquiring stock of domestic corporation N which has as to R Corporation an adjusted basis of $15,000. For purposes of determining R Corporation's aggregate investment in United States property on December 31, 1963, R Corporation has, by virtue of acquiring the stock of N Corporation, acquired $15,000 of United States property.

Example (*2*). Foreign corporation S, a controlled foreign corporation for the entire period here involved, uses the calendar year as a taxable year and purchases for $100,000 on December 31, 1963, tangible property (not described in section 956(b)(2)) located in the United States and having a remaining estimated useful life of 10 years, subject to a mortgage of $80,000 payable in 5 annual installments. The property constitutes United States property as of December 31, 1963, and the amount taken into account for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956-1 is $20,000. No depreciation is sustained with respect to the property during the taxable year 1963. During the taxable year 1964, S Corporation pays $16,000 on the mortgage and sustains $10,000 of depreciation with respect to the property. As of December 31, 1964, the amount taken into account with respect to the property for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956-1 is $26,000, computed as follows:

Cost of property		$100,000
Less: Reserve for depreciation		10,000
Adjusted basis of property		90,000
Less: Liability to which property is subject:		
Gross amount of mortgage	$80,000	
Payment during 1964	16,000	
		64,000
Amount taken into account (12-31-64)		26,000

Example (*3*). Controlled foreign corporation T uses the calendar year as a taxable year and acquires on December 31, 1963, $10,000 of United States property not described in section 956(b)(2); no depreciation is sustained with respect to the property during 1963. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956-1) as of December 31, 1963, are in excess of $10,000, and T Corporation's United States shareholders include in their gross income under section 951(a)(1)(B) their pro rata share of T Corporation's increase ($10,000) for 1963 in earnings invested in United States property. On January 1, 1964, T Corporation acquires an additional $10,000 of United States property not described in section 956(b)(2). Each of the two items of property has an estimated useful life of 5 years, and T Corporation sustains $4,000 of depreciation with respect to such properties during its taxable year 1964. Corporation T's current and accumulated earnings and profits as of December 31, 1964, exceed $16,000, determined as provided in paragraph (b) of § 1.956-1. Corporation T pays no amounts during 1963 to which section 959(c)(1) applies. Corporation T's investment of earnings in United States property at December 31, 1964, is $16,000, and its increase for 1964 in earnings invested in United States property is $6,000.

Example (4). Foreign corporation U uses the calendar year as a taxable year and acquires before January 1, 1963, stock in domestic corporation M having as to U Corporation an adjusted basis of $10,000. On December 1, 1964, pursuant to a statutory merger described in section 368(a)(1), M Corporation merges into domestic corporation N, and U Corporation receives on such date one share of stock in N Corporation, the surviving corporation, for each share of stock it held in M Corporation. Pursuant to section 354 no gain or loss is recognized to U Corporation, and pursuant to section 358 the basis of the property received (stock of N Corporation) is the same as that of the property exchanged (stock of M Corporation). Corporation U is not considered for purposes of section 956 to have acquired United States property by reason of its receipt of the stock in N Corporation.

Example (5). The facts are the same as in example (4), except that U Corporation acquires the stock of M Corporation on February 1, 1963, rather than before January 1, 1963. For purposes of determining U Corporation's aggregate investment in United States property on December 31, 1963, U Corporation has, by virtue of acquiring the stock of M Corporation, acquired $10,000 of United States property. Corporation U pays no amount during 1963 to which section 959(c)(1) applies. The reorganization and resulting acquisition on December 1, 1964, by U Corporation of N Corporation's stock also represents an acquisition of United States property; however, assuming no other change in U Corporation's aggregate investment in United States property during 1964, U Corporation's increase for such year in earnings invested in United States property is zero.

(2) *Obligation defined.* For purposes of this section, the term "obligation" includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest, except that such term shall not include—

(i) Any indebtedness arising out of the involuntary conversion of property which is not United States property within the meaning of paragraph (a)(1) of this section, or

(ii) Any indebtedness (other than an indebtedness arising in connection with the sale or processing of property) which—

(*a*) Is collected within one year from the time it is incurred, or

(*b*) Matures within one year from the time it is incurred but is not collected within such period solely by reason of the inability or unwillingness of the debtor to make payment within such period.

For purposes of (*b*) of this subdivision, a failure to collect an indebtedness within the one-year period will not be attributed to inability or unwillingness on the part of the debtor to make payment unless it is clearly established that the creditor has made reasonable efforts to collect such indebtedness within such period. See paragraph (b)(1)(v) of this section for the exclusion from United States property of obligations arising in connection with the sale or processing of property where such obligations are ordinary and necessary as to amount.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6704, 29 FR 2601, Feb. 20, 1964, as amended by T.D. 7712, 45 FR 52374, Aug. 7, 1980]

§ 1.957-1 Definition of controlled foreign corporation.

(a) *In general.* For purposes of sections 951 through 964, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent (or more than 25 percent, in a case to which section 957(b) and § 1.957-2 apply) of the total combined voting power of all classes of stock entitled to vote is owned within the meaning of section 958(a), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day of the taxable year of such foreign corporation. For definition of the term "United States shareholder," see section 951(b) and the regulations thereunder. For definition of the term "foreign corporation," see § 301.7701-5 of this chapter (Procedure and Administration Regulations). For treatment of associations as corporations, see section 7701(a)(3) and §§ 301.7701-1 and 301.7701-2 of this chapter. For definition of the term "stock," see sections 958(a)(3) and 7701(a)(7). For the classification of a member in an association, joint-stock company, or insurance company as a shareholder, see section 7701(a)(8).

(b) *Percentage of total combined voting power owned by United States shareholders*—(1) *Meaning of combined voting power.* In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage of total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case. In all cases, however, United States shareholders of a foreign corporation will be deemed to own the requisite percentage of total combined voting power with respect to such corporation—

(i) If they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation;

(ii) If any person or persons elected or designated by such shareholders have the power, where such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporation, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by such governing body; or

(iii) If the powers which would ordinarily be exercised by the board of directors of a domestic corporation are exercised with respect to such foreign corporation by a person whom such shareholders have the power to elect, appoint, or replace.

(2) *Shifting of formal voting power.* Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

(c) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Foreign corporation R has two classes of capital stock outstanding, 60 shares of class A stock, and 40 shares of class B stock. Each share of each class of stock has one vote for all purposes. E, a United States person, owns 51 shares of class A stock. Corporation R is a controlled foreign corporation.

Example (2). Foreign corporation S has three classes of capital stock outstanding, consisting of 60 shares of class A stock, 40 shares of class B stock, and 200 shares of class C stock. The owners of a majority of class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. Class C stock has no voting rights. D, a United States person, owns all of the shares of the class C stock. He also owns 31 shares of class A stock and as such an owner can elect 6 members of the board of directors. None of the remaining shares of class A stock, or the 40 shares of class B stock, is owned, or considered as owned, within the meaning of section 958, by a United States person. Since, as owner of 31 shares of the class A stock, D has sufficient voting power to elect 6 directors, D has more than 50 percent of the total combined voting power of all classes of stock entitled to vote, and S Corporation is a controlled foreign corporation.

Example (3). M, a United States person, owns a 51-percent interest in R Company, a foreign company of which he is a member. The company, if it were domestic, would be taxable as a corporation. The remaining interest of 49 percent in the company is owned by seven other members none of whom is a United States person. The memorandum of association of R Company provides for only one manager, who with respect to the company exercises the powers ordinarily exercised by a board of directors of a domestic corporation. The manager is to be elected by unanimous agreement of all the members. Since M owns 51 percent of the company, he will be deemed to own more than 50 percent of the total combined voting power of all classes of stock of R Company entitled to vote, notwithstanding that he has power to elect a manager only with the agreement of the other members. Company R is a controlled foreign corporation.

Example (4). Domestic corporation M owns a 49-percent interest in S Company, a foreign company of which it is a member. The company, if it were domestic, would be taxable as a corporation. Company S is formed under the laws of foreign country Y. The remaining interest of 51 percent in S Company is owned by persons who are not United States persons. The organization contract of S Company provides for one manager, B, a citizen and resident of country Y who is an officer of M Corporation in charge of its foreign operations in such country, or any person M Corporation may at any time appoint to succeed B in such capacity. The manager has the sole authority with respect to S Company to exercise powers ordinarily exercised by a board of directors of a domestic corporation. Since M Corporation has the discretionary power to replace B and to appoint his successor as manager of S Company, the company is a controlled foreign corporation.

Example (5). N, a United States person, owns 50 percent of the outstanding shares of the only class of capital stock of foreign corporation R. An additional 48 percent of the outstanding shares is owned by foreign corporation S. The remaining 2 percent of shares is owned by P, a citizen and resident of foreign country T, who regularly acts as attorney for N in the conduct of N's business affairs in country T. All of the shares of the outstanding capital stock of R Corporation are bearer shares. At the time of the issuance of the shares to him, P places the certificates for such shares in a depository to which N has access. On several occasions N, with P's acquiescence, has taken such shares from the depository and, on one such occasion, used the shares as collateral in borrowing funds on a loan. Although dividends, when paid, are paid to P on his shares, his charges to N for legal fees are reduced by the amount of the dividends paid on such shares. Although P votes his shares at meetings of shareholders, the facts set forth above indicate an implied agreement between P and N that N is really to retain dominion over the stock. N is deemed to own the voting rights ostensibly attached to the stock owned by P, and R Corporation is a controlled foreign corporation.

Example (6). M, a domestic corporation which manufactures in the United States and distributes all of its production for foreign consumption through N, a person other than a related person or a United States person, forms foreign corporation S to purchase products from M Corporation and sell them to N. Corporations S and M have common directors. The outstanding capital stock of S Corporation consists of 10,000 shares of $100 par value class A stock, which has no voting rights except to vote for dissolution of the corporation on a share-for-share basis, and 500 shares of no par class B stock which has full voting rights. Each class of the outstanding stock is to participate on a share for share basis in any dividend. The class A stock has a preference as to assets on dissolution of the corporation to the extent of its par value as well as the right to participate with the class B stock in all other assets on a share for share basis. All of the shares of class A stock are issued to M Corporation in return for property having a value of $1 million. Of the class B stock, 300 of the shares are issued to N in return for $3,000 in cash and 200 shares are issued to M Corporation for $2,000 in cash. At stockholder meetings N never votes in opposition to M Corporation on important issues. Corporation S has average annual earnings of $200,000, all of which will be subpart F income if S Corporation is held to be a controlled foreign corporation. All such earnings are accumulated. Although N ostensibly has 60 percent of the voting power of S Corporation by virtue of his ownership of 300 shares of class B stock, he has the right to only approximately 3 percent of any dividends which may be paid by S Corporation; in addition, upon liquidation of S Corporation, N is entitled to share in the assets only after M Corporation has received the par value of its 10,000 shares of class A stock, or $1 million. Thus, the voting power owned by N is substantially greater than its proportionate share of the earnings of S Corporation. In addition, the facts set forth above indicate that N is not exercising his voting rights independently and that a principal purpose of the capitalization arrangement is to avoid classification of S Corporation as a controlled foreign corporation. For these reasons, the voting power ostensibly provided the class B stock will be deemed owned by M Corporation, and S Corporation is a controlled foreign corporation.

Example (7). Foreign corporation A, authorized to issue 100 shares of one class of capital stock, issues, for $1,000 per share, 45 shares to domestic corporation M, 45 shares to foreign corporation B, and 10 shares to foreign corporation C. Corporation C, a bank, lends $3 million to finance the operations of A Corporation. In the course of negotiating these financial arrangements, D, an officer of C Corporation, and E, an officer of M Corporation, orally agree that C Corporation will vote its stock as M Corporation directs. By virtue of such oral agreement M Corporation possesses the voting power ostensibly owned by C Corporation, and A Corporation is a controlled foreign corporation.

[T.D. 6688, 28 FR 11631, Oct. 31, 1963]

§ 1.957-2 Controlled foreign corporation deriving income from insurance of United States risks.

(a) *In general.* For purposes of taking into account only the income derived from the insurance of United States risks under § 1.953-1, the term "controlled foreign corporation" means any foreign corporation of which more than 25 percent, but not more than 50 percent, of the total combined voting power of all classes of stock entitled to vote is owned within the meaning of section 958(a), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day of the taxable year of such foreign corporation, but only if the gross amount of premiums received by such foreign corporation during such taxable year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with United States risks, as defined in § 1.953-2 or 1.953-3, exceeds 75 percent of the gross amount of all premiums received by such foreign corporation during such year which are attributable to the reinsuring and the issuing of insurance and annuity contracts in connection with all risks. The subpart F income for a taxable year of a foreign corporation which is a controlled foreign corporation for such taxable year within the meaning of this paragraph shall, subject to the provisions of section 952(b), (c), and (d), and § 1.952-1, include only the income derived from the insurance of United States risks, as determined under § 1.953-1.

(b) *Gross amount of premiums defined.* For a foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as—

(1) A life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies,

(2) A mutual insurance company to which part II (sections 821 through 826) of subchapter L of the Code applies, or

(3) A mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of the Code applies,

the term "gross amount of premiums" means, for purposes of paragraph (a) of this section, the gross amount of premiums and other consideration which are taken into account by a life insurance company under section 809(c)(1). Determinations for purposes of this paragraph shall be made without regard to section 501(a).

[T.D. 6795, 30 FR 942, Jan. 29, 1965]

§ 1.957-3 Corporations organized in United States possessions.

(a) *General rule.* For purposes of sections 951 through 964, a corporation created or organized in a possession of the United States or under the laws of a possession of the United States shall not be treated as a controlled foreign corporation for any taxable year if—

(1) 80 percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year or for such part of such 3-year period as such corporation was in existence or for such part of such 3-year period as occurs on and after the beginning of such corporation's first annual accounting period beginning after December 31, 1962, whichever period is shortest, was derived from sources within a possession of the United States; and

(2) 50 percent or more of the gross income of such corporation for such period, or for such part of such period, was derived from the active conduct within a possession of the United States of one or more trades or businesses constituting—

(i) The manufacture or processing of goods, wares, merchandise, or other tangible personal property;

(ii) The processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, or fur-bearing animals);

(iii) The catching or taking of any kind of fish, or any manufacturing or processing of any products or commodities obtained from such activities;

(iv) The mining or extraction of natural resources, or any manufacturing or processing of any products or commodities obtained from such activities; or

(v) The ownership or operation of hotels.

(b) *Special provisions.* For purposes of section 957(c) and this section—

(1) *United States defined.* The term "United States" includes only the States and the District of Columbia.

(2) *Possession of the United States defined.* The term "possession of the United States" includes Guam, the Midway Islands, the Panama Canal Zone, the Commonwealth of Puerto Rico, American Samoa, the Virgin Islands, and Wake Island.

(3) *Determination of source of gross income.* Whether gross income of a corporation referred to in paragraph (a) of this section is derived from sources within a possession of the United States shall be determined by the application of the provisions of § 1.955-6 except that, for purposes of making such determination, the term "produced", as used in paragraph (d)(2) of § 1.955-6, shall also include the activities described in paragraph (a)(2) (i) through (iv) of this section and the activities considered, under subparagraph (4) of this paragraph, to be qualifying trades or businesses.

(4) *Manufacturing or processing.* The trades or businesses which qualify under the provisions of paragraph (a)(2) of this section shall include, but not be limited to, the manufacture of tabulating cards, paper tablets or pads, facial tissues, and paper napkins from rolls of paper; the manufacture of such household products as liquid starch by mixing quantities of the ingredients which are used to produce liquid starch; and the manufacture of juices and drinks from fruit concentrates. In the application of paragraph (a)(2) of this section, proper regard shall be given to the classification of a trade or business as a manufacturing or processing activity under the applicable economic incentive law of the possession involved. The fact that an activity of a corporation qualifies as a trade or business for purposes of paragraph (a) of this section does not necessarily mean that such activity constitutes a substantial transformation of property within the meaning of paragraph (a)(4) of § 1.954-3 for purposes of determining any foreign base company income of such corporation.

[T.D. 6683, 28 FR 11184, Oct. 18, 1963]

§ 1.957-4 United States person defined.

(a) *Basic rule*—(1) *In general.* The term "United States person" has the same meaning for purposes of sections 951 through 964 which it has under section 7701(a)(30) and in the regulations thereunder, except as provided in section 957(d) and paragraphs (b), (c), and (d) of this section which provide, with respect to corporations organized in possessions of the United States, that certain residents of such possessions are not United States persons. The effect of determining that an individual is not a United States person for such purposes is to exclude such individual in determining whether a foreign corporation created or organized in, or under the laws of, Puerto Rico, the Virgin Islands, or any possession of the United States (other than Puerto Rico or the Virgin Islands) is a controlled foreign corporation. See § 1.957-1 for definition of the term "controlled foreign corporation"; § 1.957-2 for a special limitation on the amount of subpart F income of certain controlled foreign corporations deriving income from the insurance of United States risks; and § 1.957-3 for the exclusion of certain corporations organized in United States possessions from the definition of controlled foreign corporation.

(2) *Special provisions applicable to possessions of the United States.* For purposes of section 957(d) and this section—

(i) *Possession of the United States defined.* The term "possession of the United States" has the same meaning which it has under paragraph (b)(2) of § 1.957-3.

(ii) *Determination of residence in a possession.* Whether an individual is a bona fide resident of Puerto Rico, the Virgin Islands, or any other possession of the United States, shall be determined in general by applying to the facts and circumstances in each case the principles of §§ 1.871-2 through 1.871-5, relating to the determination of residence in the United States.

(b) *Puerto Rico corporation and resident.* With respect only to a foreign corporation created or organized in, or under the laws of, Puerto Rico—

(1) If an individual (who, without regard to this paragraph, is a United States person) is a bona fide resident of Puerto Rico during his entire taxable year in which or with which the taxable year of such foreign corporation ends, and

(2) If 50 percent or more of the gross income of such foreign corporation is derived from sources within Puerto Rico, as determined under § 1.863-6, for the 3-year period (or for such part of such 3-year period as such foreign corporation has been in existence) ending with the close of the taxable year of such foreign corporation which—

(i) Ends with or within the taxable year next preceding such taxable year of such individual and at any time, during the period beginning with the beginning of such latter taxable year of such individual and ending not later than one year after the close of such taxable year of such foreign corporation, such individual directly owns stock in such foreign corporation, or

(ii) Ends within such taxable year of such individual and at any time, during the period beginning after the close of such taxable year of such foreign corporation and ending with the close of such taxable year of such individual, such individual directly owns stock in such foreign corporation,

then, such individual shall not be considered a United States person with respect to such corporation for the taxable year of such corporation which ends with or within the taxable year of such person. The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation R, incorporated under the laws of Puerto Rico, is wholly owned by D, a United States citizen. D and corporation R use the calendar year as the taxable year. For 1961, 1962, and 1963, 60 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 40 percent of the gross income of R Corporation is derived from sources within Panama, as determined under § 1.863-6. During all of 1964, D is a bona fide resident of Puerto Rico. D is not a United States person with respect to R Corporation for 1964. Accordingly, R Corporation is not a controlled foreign corporation at any time in 1964.

Example (2). Foreign corporation R is incorporated on January 1, 1962, under the laws of Puerto Rico. D, a United States citizen, owns all the one class of stock of R Corporation throughout 1962 and 1963. D and corporation R use the calendar year as the taxable year. For 1962, 55 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 45 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under § 1.863-6. For 1963, 40 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 60 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under § 1.863-6. During all of 1963 D is a bona fide resident of Puerto Rico. With respect to R Corporation, D is not a United States person for 1963 because D is a bona fide resident of Puerto Rico for all of 1963; 55 percent of the gross income of R Corporation for 1962 is derived from sources within Puerto Rico; and D owns stock in R Corporation at some time during 1963. Accordingly, R Corporation is not a controlled foreign corporation at any time in 1963. In making this determination, it is immaterial that R Corporation does not satisfy the 50-percent gross income test for 1963, the taxable year during all of which D is a resident of Puerto Rico.

Example (3). Foreign corporation R is incorporated on January 1, 1962, under the laws of Puerto Rico. D, a United States citizen, owns all the one class of stock of R Corporation throughout 1962 and 1963. D and corporation R use the calendar year as the taxable year. For 1962, 45 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 55 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under § 1.863-6. For 1963, 60 percent of the gross income of R Corporation is derived from sources within Puerto Rico and 40 percent of the gross income of R Corporation is derived from sources within the Netherlands Antilles, as determined under § 1.863-6. With respect to R Corporation, D is a United States person for 1963, since R Corporation does not satisfy the 50-percent gross income test for 1962. Accordingly, R Corporation is a controlled foreign corporation for all of 1963.

Example (4). Foreign corporation S is incorporated on July 1, 1962, under the laws of Puerto Rico. Corporation S uses the fiscal year ending on June 30 as the taxable year. For its fiscal year ending on June 30, 1963, 55 percent of the gross income of S Corporation is derived from sources within Puerto Rico and 45 percent of the gross income of S Corporation is derived from sources within Switzerland, as determined under § 1.863-6. For its fiscal years ending on June 30, 1964, and June 30, 1965, respectively, 40 percent of the gross income of S Corporation is derived from sources within Puerto Rico and 60 percent of the gross income of S Corporation is derived from sources within Switzerland, as determined under § 1.863-6. B, a United States citizen, who uses the calendar year as the taxable year, is a bona fide resident of Puerto Rico for all of 1964. On July 1, 1964, B acquires, and holds throughout the remainder of 1964, all of the one class of stock of S Corporation. With respect to S Corporation for its taxable year ending June 30, 1964, B is a United States person because—

(a) Although B is a bona fide resident of Puerto Rico for his entire year 1964 in which ends S Corporation's taxable year ending June 30, 1964, and S Corporation meets the 50-percent gross income test for the applicable part of the 3-year period ending June 30, 1963, B does not own stock in S Corporation during the period beginning January 1, 1964, and ending June 30, 1964, and

(b) Although B owns stock in S Corporation during the period beginning July 1, 1964, and ending December 31, 1964, S Corporation does not meet the 50-percent gross income test for the applicable part of the 3-year period ending June 30, 1964.

Accordingly, with respect to B, S Corporation is a controlled foreign corporation for its entire taxable year ending June 30, 1964.

Example (5). The facts are the same as in example (4), except B buys all of the stock of S Corporation on June 1, 1964, rather than on July 1, 1964. With respect to S Corporation for its taxable year ending June 30, 1964, B is not a United States person because B is a bona fide resident of Puerto Rico for his entire taxable year 1964 in which ends S Corporation's taxable year ending June 30, 1964; S Corporation meets the 50-percent gross income test for the applicable part of the 3-year period ending June 30, 1963; and B owns stock in S Corporation during the period beginning January 1, 1964, and ending June 30, 1964. Accordingly, with respect to B, S Corporation is not a controlled foreign corporation at any time during its taxable year ending June 30, 1964.

(c) *Virgin Islands corporation and President.* With respect only to a foreign corporation created or organized in, or under the laws of, the Virgin Islands—

(1) If an individual (who, without regard to this paragraph, is a United States person) is a bona fide resident of the Virgin Islands as of the last day of his taxable year in which or with which the taxable year of such foreign corporation ends, and

(2) Such individual's income tax obligations under subtitle A (relating to income taxes) of the Code for his taxable year are satisfied, in accordance with section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642), by paying the tax on his income derived from all sources, both within and outside the Virgin Islands,

into the treasury of the Virgin Islands, then, such individual shall not be considered a United States person with respect to such corporation for the taxable year of such corporation which ends with or within the taxable year of such person. The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation S, incorporated under the laws of the Virgin Islands, is wholly owned by D, a United States citizen. Corporation S uses the fiscal year ending on June 30 as the taxable year, and D uses the calendar year as the taxable year. From September 1, 1963, to December 31, 1964, inclusive, D is a bona fide resident of the Virgin Islands. For 1963 and 1964, D satisfies his income tax obligations under section 28(a) of the Revised Organic Act of the Virgin Islands by paying the tax on his income derived from all sources, both within and outside the Virgin Islands, into the treasury of the Virgin Islands. With respect to S Corporation for its taxable years ending June 30, 1963, and 1964, D is not a United States person. Accordingly, S Corporation is not a controlled foreign corporation for such taxable years of such corporation.

Example (2). The facts are the same as in example (1), except that from August 15, 1964, to December 31, 1964, inclusive, D is a bona fide resident of the United States. Thus, D does not satisfy his income tax obligations for 1964 under section 28(a) of the Revised Organic Act of the Virgin Islands. The result is the same as in example (1), except that with respect to S Corporation for its taxable year ending June 30, 1964, D is a United States person and, accordingly, S Corporation is a controlled foreign corporation for such taxable year of such corporation.

(d) *Corporation and resident of other United States possessions.* With respect only to a foreign corporation created or organized in, or under the laws of, any possession of the United States (other than Puerto Rico or the Virgin Islands)—

(1) If an individual (who, without regard to this paragraph, is a United States person) is a bona fide resident of such possession during his entire taxable year in which or with which the taxable year of such foreign corporation ends, and

(2) Any part or all of such individual's income (other than amounts includible in his gross income under section 951(a)) for his taxable year derived, in accordance with § 1.863-6, from sources within any possession of the United States (whether or not the possession of which such individual is a resident) is not, as a result of the application of section 931, included in his gross income for his taxable year,

then, such individual shall not be considered a United States person with respect to such corporation for the taxable year of such corporation which ends with or within the taxable year of such person. Subparagraph (2) of this paragraph shall apply only for purposes of determining whether an individual is a United States person; after such determination has been made, section 931 shall be applied to the gross income (including amounts includible in gross income under section 951(a)) of such individual to determine the amount to be excluded from such individual's gross income under section 931. The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation R, incorporated under the laws of Guam, is wholly owned by D, a United States citizen. D and corporation R use the calendar year as the taxable year and the cash receipts and disbursements method of accounting. D is a bona fide resident of Guam for all of 1963 and all of his income of $30,000 (determined without taking into account amounts includible in his gross income under section 951(a)) is derived from sources within Guam. Of such income, $24,000 is received in Guam and $6,000 is erceived in the United States. It meets the 3-year test of section 931(a) and, but for the application of section 931(b), all of his income of $30,000 would be excluded from gross income for 1963 under section 931. However, in accordance with section 931(b) and paragraph (c) of § 1.931-1, the $6,000 received in the United States is included in gross income. Nevertheless, since part ($24,000) of his income of $30,000 for 1963 derived, in accordance with § 1.863-6, from sources within Guam is not, as a result of the application of section 931, included in his gross income, D is not a United States person with respect to R Corporation for its taxable year 1963. Accordingly, R Corporation is not a controlled foreign corporation for its taxable year 1963.

Example (2). The facts are the same as in example (1), except that, instead of receiving the $6,000 in the United States, D receives $10,000 of the $30,000 in Guam for services performed for an agency of the

United States. Under § 1.863-6, all of D's income for 1963 is income derived from sources within Guam. However, since D's income of $10,000 from the agency of the United States is deemed under section 931 (i) to be derived from sources within the United States for purposes of section 931, at least 80 percent of his gross income for 1963, determined without the application of section 931, is not derived from sources within Guam. Accordingly, since no part of D's gross income of $30,000 for 1963 derived, in accordance with § 1.863-6, from sources within Guam is, as a result of the application of section 931, excluded from gross income for 1963, D is a United States person with respect to R Corporation for R Corporation's taxable year 1963. Accordingly, R Corporation is a controlled foreign corporation for its taxable year 1963.

[T.D. 6775, 29 FR 16082, Dec. 2, 1964]

§ 1.958-1 Direct and indirect ownership of stock.

(a) *In general.* Section 958(a) provides that, for purposes of sections 951 to 964 (other than sections 955(b)(1)(A) and (B), 955(c)(2)(A)(ii), and 960(a)(1)), stock owned means—

(1) Stock owned directly; and

(2) Stock owned with the application of paragraph (b) of this section.

The rules of section 958(a) and this section provide a limited form of stock attribution primarily for use in determining the amount taxable to a United States shareholder under section 951(a). These rules also apply for purposes of other provisions of the Code and regulations which make express reference to section 958(a).

(b) *Stock ownership through foreign entities.* For purposes of paragraph (a)(2) of this section, stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries, respectively. Stock considered to be owned by reason of the application of this paragraph shall, for purposes of reapplying this paragraph, be treated as actually owned by such person. Thus, this rule creates a chain of ownership; however, since the rule applies only to stock owned by a foreign entity, attribution under the rule stops with the first United States person in the chain of ownership running from the foreign entity. The application of this paragraph may be illustrated by the following example:

Example. Domestic corporation M owns 75 percent of the one class of stock in foreign corporation R, which in turn owns 80 percent of the one class of stock in foreign corporation S, which in turn owns 90 percent of the one class of stock in foreign corporation T. Under this paragraph, R Corporation is considered as owning 80 percent of the 90 percent of the stock which S Corporation owns in T Corporation, or 72 percent. Corporation M is considered as owning 75 percent of such 72 percent of the stock in T Corporation, or 54 percent. Since M Corporation is a domestic corporation, the attribution under this paragraph stops with M Corporation, even though, illustratively, such corporation is wholly owned by domestic corporation N.

(c) *Rules of application*—(1) *Special rule for mutual insurance companies.* For purposes of applying paragraph (a) of this section in the case of a foreign mutual insurance company, the term "stock" shall include any certificate entitling the holder to voting power in the corporation.

(2) *Amount of interest in foreign corporation, foreign partnership, foreign trust, or foreign estate.* The determination of a person's proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation. If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person. Howev-

er, any arrangement which artificially decreases a United States person's proportionate interest will not be recognized. See §§ 1.951-1 and 1.957-1.

(d) *Illustration.* The application of this section may be illustrated by the following examples:

Example (1). United States persons A and B own 25 percent and 50 percent, respectively, of the one class of stock in foreign corporation M. Corporation M owns 80 percent of the one class of stock in foreign corporation N, and N Corporation owns 60 percent of the one class of stock in foreign corporation P. Under paragraph (b) of this section, M Corporation is considered to own 48 percent (80 percent of 60 percent) of the stock in P Corporation; such 48 percent is treated as actually owned by M Corporation for the purpose of again applying paragraph (b) of this section. Thus, A and B are considered to own 12 percent (25 percent of 48 percent) and 24 percent (50 percent of 48 percent), respectively, of the stock in P Corporation.

Example (2). United States person C is a 60-percent partner in foreign partnership X. Partnership X owns 40 percent of the one class of stock in foreign corporation Q. Corporation Q is a 50-percent partner in foreign partnership Y, and partnership Y owns 100 percent of the one class of stock in foreign corporation R. By the application of paragraph (b) of this section, C is considered to own 12 percent (60 percent of 40 percent of 50 percent of 100 percent) of the stock in R Corporation.

Example (3). Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (⅓ of 90 percent) of the stock in S Corporation.

Example (4). Among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.

[T.D. 6889, 31 FR 9455, July 12, 1966]

§ 1.958-2 Constructive ownership of stock.

(a) *In general.* Section 958(b) provides that, for purposes of sections 951(b), 954(d)(3), 956(b)(2), and 957, the rules of section 318(a) as modified by section 958(b) and this section shall apply to the extent that the effect is to treat a United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of a controlled foreign corporation under section 956(b)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957. The rules contained in this section also apply for purposes of other provisions of the Code and regulations which make express reference to section 958(b).

(b) *Members of family*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, an individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) His spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance); and

(ii) His children, grandchildren, and parents.

(2) *Effect of adoption.* For purposes of subparagraph (1)(ii) of this paragraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(3) *Stock owned by nonresident alien individual.* For purposes of this paragraph, stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a United States citizen or a resident alien individual. However, this limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and § 1.956-2(b)(1)(viii). See section 958(b)(1).

(c) *Attribution from partnerships, estates, trusts, and corporations*—(1) *In* *general.* Except as provided in subparagraph (2) of this paragraph—

(i) *From partnerships and estates.* Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

(ii) *From trusts—(a) To beneficiaries.* Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

(*b*) *To owner.* Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under sections 671 to 678 (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(iii) *From corporations.* If 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. See section 958(b)(3).

(2) *Rules of application.* For purposes of subparagraph (1) of this paragraph, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote in a corporation, it shall be considered as owning all the stock entitled to vote. See section 958(b)(2).

(d) *Attribution to partnerships, estates, trusts, and corporations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph—

(i) *To partnerships and estates.* Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(ii) *To trusts—(a) From beneficiaries.* Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of the preceding sentence, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

(*b*) *From owner.* Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under sections 671 to 678 (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(iii) *To corporations.* If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. This subdivision shall not be applied so as to consider a corporation as owning its own stock.

(2) *Limitation.* Subparagraph (1) of this paragraph shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. This limitation does not apply for purposes of determining whether the stock of a domestic corporation is owned or considered as owned by a United States shareholder under section 956(b)(2) and § 1.956-2(b)(1)(viii). See section 958(b)(4).

(e) *Options.* If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of the preceding sentence, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(f) *Rules of application.* For purposes of this section—

(1) *Stock treated as actually owned*—(i) *In general.* Except as provided in subdivisions (ii) and (iii) of this subparagraph, stock constructively owned by a person by reason of the application of paragraphs (b), (c), (d), and (e) of this section shall, for purposes of applying such paragraphs, be considered as actually owned by such person.

(ii) *Members of family.* Stock constructively owned by an individual by reason of the application of paragraph (b) of this section shall not be considered as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

(iii) *Partnerships, estates, trusts, and corporation.* Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (d) of this section shall not be considered as owned by it for purposes of applying paragraph (c) of this section in order to make another the constructive owner of such stock.

(iv) *Option rule in lieu of family rule.* For purposes of this subparagraph, if stock may be considered as owned by an individual under paragraph (b) or (e) of this section, it shall be considered as owned by him under paragraph (e).

(2) *Coordination of different attribution rules.* For purposes of any one determination, stock which may be owned under more than one of the rules of § 1.958–1 and this section, or by more than one person, shall be owned under that attribution rule which imputes to the person, or persons, concerned the largest total percentage of such stock. The application of this subparagraph may be illustrated by the following examples:

Example (1). (a) United States persons A and B, and domestic corporation M, own 9 percent, 32 percent, and 10 percent, respectively, of the one class of stock in foreign corporation R. A also owns 10 percent of the one class of stock in M Corporation. For purposes of determining whether A is a United States shareholder with respect to R Corporation, 10 percent of the 10-percent interest of M Corporation in R Corporation is considered as owned by A. See paragraph (c)(1)(iii) of this section. Thus, A owns 10 percent (9 percent plus 10 percent of 10 percent) of the stock in R Corporation and is a United States shareholder with respect to such corporation. Corporation M and B, by reason of owning 10 percent and 32 percent, respectively, of the stock in R Corporation are United States shareholders with respect to such corporation.

(b) For purposes of determining whether R Corporation is a controlled foreign corporation, the 1 percent of the stock in R Corporation directly owned by M Corporation and considered as owned by A cannot be counted twice. Therefore, the total amount of stock in R Corporation owned by United States shareholders is 51 percent, determined as follows:

STOCK OWNERSHIP IN R CORPORATION

[percent]

A	9
B	32
M Corporation	10
Total	51

Example (2). United States person C owns 10 percent of the one class of stock in foreign corporation N, which owns 60 percent of the one class of stock in foreign corporation S. Under paragraph (a)(2) of § 1.958–1, C is considered as owning 6 percent (10 percent of 60 percent) of the stock in S Corporation. Under paragraph (c)(1)(iii) and (2) of this section N Corporation is considered as owning 100 percent of the stock in S Corporation and C is considered as owning 10 percent of such 100 percent, or 10 percent of the stock in S Corporation. Thus, for purposes of determining whether C is a United States shareholder with respect to S Corporation, the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used inasmuch as C owns a larger total percentage of the stock of S Corporation under such rules.

(g) *Illustration.* The application of this section may be illustrated by the following examples:

Example (1). United States persons A and B own 5 percent and 25 percent, respectively, of the one class of stock in foreign corporation M. Corporation M owns 60 percent of the one class of stock in foreign corporation N. Under paragraph (a)(2) of § 1.958–1, A and B are considered as owning 3 percent (5 percent of 60 percent) and 15 percent (25 percent of 60 percent), respectively, of the stock in N Corporation. Under paragraph (c)(2) of this section, M Corporation is treated as owning all the stock in N Corporation, and, under paragraph (c)(1)(iii) of this section, B is considered as owning 25 percent of such 100 percent, or 25 percent of the stock in N Corporation. Inasmuch as A owns less than 10 percent of the stock in M Corporation, he is not considered as owning, under paragraph (c)(1)(iii) of this section, any of the stock in N Corporation owned by M Corporation. Thus, the attribution rules of paragraph (a)(2) of § 1.958–1 are used with respect to A inasmuch as he owns a larger total percentage of the stock of N Corporation under such rules; and the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used with respect to B inasmuch as he owns a larger total percentage of the stock of N Corporation under such rules.

Example (2). United States person C owns 60 percent of the one class of stock in domestic corporation P; corporation P owns 60 percent of the one class of stock in foreign corporation Q; and corporation Q owns 60 percent of the one class of stock in foreign corporation R. Under paragraph (a)(2) of § 1.958-1, P Corporation is considered as owning 36 percent (60 percent of 60 percent) of the stock in R Corporation, and C is considered as owning none of the stock in R Corporation inasmuch as the chain of ownership stops at the first United States person and P Corporation is such a person. Under paragraph (c)(2) of this section, Q Corporation is treated as owning 100 percent of the stock in R Corporation, and under paragraph (c)(1)(iii) of this section, P Corporation is considered as owning 60 percent of such 100 percent, or 60 percent of the stock in R Corporation. For purposes of determining the amount of stock in R Corporation which C is considered as owning, P Corporation is treated under paragraph (c)(2) of this section as owning 100 percent of the stock in R Corporation; therefore, C is considered as owning 60 percent of the stock in R Corporation. Thus, the attribution rules of paragraph (c)(1)(iii) and (2) of this section are used with respect to C and P Corporation inasmuch as they each own a larger total percentage of the stock of R Corporation under such rules.

Example (3). United States person D owns 25 percent of the one class of stock in foreign corporation S. D is also a 40-percent partner in domestic partnership X, which owns 50 percent of the one class of stock in domestic corporation T. Under paragraph (d)(1)(i) of this section, the 25 percent of the stock in S Corporation owned by D is considered as being owned by partnership X; since such stock is treated as actually owned by partnership X under paragraph (f)(1)(i) of this section, such stock is in turn considered as being owned by T Corporation under paragraph (d)(1)(iii) of this section. Thus, under paragraphs (d)(1) and (f)(1)(i) of this section, T Corporation is considered as owning 25 percent of the stock in S Corporation.

Example (4). Foreign corporation U owns 100 percent of the one class of stock in domestic corporation V and also 100 percent of the one class of stock in foreign corporation W. By virtue of paragraph (d)(2) of this section, V Corporation may not be considered under paragraph (d)(1) of this section as owning the stock owned by its sole shareholder, U Corporation, in W Corporation.

Example (5). United States citizen E owns 15 percent of the one class of stock in foreign corporation Y, and United States citizen F, E's spouse, owns 5 percent of such stock. E and F's four nonresident alien grandchildren each own 20 percent of the stock in Y Corporation. Under paragraph (b)(1) of this section, E is considered as owning the stock owned by F in Y Corporation; however, by virtue of paragraph (b)(3) of this section, E may not be considered under paragraph (b)(1) of this section as owning any of the stock in Y Corporation owned by such grandchildren.

Example (6). United States person F owns 10 percent of the one class of stock in foreign corporation Z; corporation Z owns 10 percent of the one class of stock in foreign corporation K; and corporation K owns 100 percent of the one class of stock in foreign corporation L. United States person G, F's spouse, owns 9 percent of the stock in K Corporation. Under paragraph (c)(1)(iii) of this section or paragraph (a)(2) of § 1.958-1, F is considered as owning 1 percent (10 percent of 10 percent of 100 percent) of the stock in L Corporation by reason of his ownership of stock in Z Corporation, and, under paragraph (b)(1) of this section, G is considered as owning such 1 percent of the stock in L Corporation. Under paragraph (a)(2) of § 1.958-1, G is considered as owning 9 percent (9 percent of 100 percent) of the stock in L Corporation by reason of her ownership of stock in K Corporation, and, under paragraph (b)(1) of this section, F is considered as owning such 9 percent of the stock in L Corporation. Thus, for the purpose of determining whether F or G is a United States shareholder with respect to L Corporation, each of F and G is considered as owning a total of 10 percent of the stock in L Corporation by applying the rules of paragraph (a)(2) of § 1.958-1 and paragraphs (b)(1) and (c)(1)(iii) of this section.

(Secs. 956(c), 7805, Internal Revenue Code of 1954 (76 Stat. 1017, 68A Stat. 917; (26 U.S.C. 956(c) and 7805 respectively)))

[T.D. 6889, 31 FR 9455, July 12, 1966, as amended by T.D. 7712, 45 FR 52375, Aug. 7, 1980]

§ 1.959-1 Exclusion from gross income of United States persons of previously taxed earnings and profits.

(a) *In general.* Sections 951 through 964 provide that certain types of income of controlled foreign corporations will be subject to United States income tax even though such amounts are not currently distributed to the United States shareholders of such corporations. The amounts so taxed to certain United States shareholders are described as subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and increases in earnings invested in United States property. Section 959 provides that amounts taxed as subpart F income or as previously excluded subpart F income withdrawn from investment in less developed countries are not taxed again as increases in earnings invested in United States property. Section 959 also provides an exclusion whereby none of the amounts so taxed are taxed again when actually distributed directly, or indirectly through a chain of ownership described in section 958(a), to United States shareholders or to such shareholders' successors in interest. The exclusion also applies to amounts taxed to United States shareholders as income of one controlled foreign corporation and later distributed to another controlled foreign corporation in such a chain of ownership where such amounts would otherwise be again included in the income of such shareholders or their successors in interest as subpart F income of the controlled foreign corporation to which they are distributed. Section 959 also provides rules for the allocation of distributions to earnings and profits and for the non-dividend treatment of actual distributions which are excluded from gross income.

(b) *Actual distributions to United States persons.* The earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder of such corporation under section 951(a) shall not, when such amounts are distributed to such shareholder directly, or indirectly through a chain of ownership described in section 958(a), be again included in the gross income of such United States shareholder. See section 959(a)(1). Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951(a)(1)(A)(i) as subpart F income, under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries, or under section 951(a)(1)(B) as earnings invested in United States property, shall not be again included in the gross income of such shareholder when such amounts are actually distributed, directly or indirectly, to such shareholder. See paragraph (d) of this section for exclusion applicable to such shareholder's successor in interest. The application of this paragraph may be illustrated by the following example:

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1963, which is a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation derives $100 of subpart F income, and A includes such amount in his gross income under section 951(a)(1)(A)(i). Corporation R's current and accumulated earnings and profits (before taking into account distributions made during 1964) are $150. Also, during 1964, R Corporation distributes $50 to A. The $50 distribution is excludable from A's gross income for 1964 under this paragraph and § 1.959-3 because such distribution represents earnings and profits attributable to amounts which are included in A's gross income for such year under section 951(a).

(c) If instead of deriving the $100 of subpart F income in 1964, R Corporation derives such amount during 1963 and has earnings and profits for 1963 in excess of $100, A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i). However, the $50 distribution made by R Corporation to A during 1964 is excludable from A's gross income for such year under this paragraph and § 1.959-3 because such distribution represents earnings and profits attributable to amounts which have been included in A's gross income for 1963 under section 951(a).

(d) If, with respect to 1964—

(1) Instead of owning the stock of R Corporation directly, A owns such stock through a chain of ownership described in section 958(a), that is, A owns 100 percent of M Corporation which owns 100 percent of N Corporation which owns 100 percent of R Corporation,

(2) Both M and N Corporations use the calendar year as a taxable year and are controlled foreign corporations throughout the period here involved,

(3) Corporation R derives $100 of subpart F income and has earnings and profits in excess of $100,

(4) Neither M Corporation nor N Corporation has earnings and profits or a deficit in earnings and profits, and

(5) The $50 distribution is from R Corporation to N Corporation to M Corporation to A,

A must include $100 in his gross income for 1964 under section 951(a)(1)(A)(i) by reason of his indirect ownership of R Corporation. However, the $50 distribution is excludable from A's gross income for 1964 under this paragraph and § 1.959-3 because such distribution represents earnings and profits attributable to amounts which are included in A's gross income for such year under section 951(a) and are distributed indirectly to A through a chain of ownership described in section 958(a).

(c) *Excludable investment of earnings in United States property.* The earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder of such corporation under section 951(a)(1)(A) shall not, when such amounts would, but for section 959(a)(2) and this paragraph, be included under section 951(a)(1)(B) in the gross income of such shareholder directly, or indirectly through a chain of ownership described in section 958(a), be again included in the gross income of such United States shareholder. Thus, earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder of a foreign corporation under section 951(a)(1)(A)(i) as subpart F income or under section 951(a)(1)(A)(ii) as previously excluded subpart F income withdrawn from investment in less developed countries may be invested in United States property without being again included in such shareholder's income under section 951(a). Moreover, the first amount deemed invested in United States property are amounts previously included in the gross income of a United States shareholder under section 951(a)(1)(A). See paragraph (d) of this section for exclusion applicable to such shareholder's successor in interest. The application of this paragraph may be illustrated by the following example:

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1963, which is a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation derives $35 of subpart F income, and A includes such amount in his gross income under section 951(a)(1)(A)(i). During 1964, R Corporation also invests $50 in tangible property (other than property described in section 956(b)(2)) located in the United States. Corporation R makes no distributions during the year, and its current earnings and profits are in excess of $50. Of the $50 investment of earnings in United States property, $35 is excludable from A's gross income for 1964 under section 959(a)(2) because such amount represents earnings and profits which are attributable to amounts which are included in A's gross income for such year under section 951(a)(1)(A)(i) and therefore may be invested in United States property without again being included in A's gross income. The remaining $15 is includible in A's gross income for 1964 under section 951(a)(1)(B).

(c) If, instead of deriving $35 of subpart F income in 1964, R Corporation has no subpart F income for 1964 but derives the $35 of subpart F income during 1963 and has earnings and profits for such year in excess of $35, A must include $35 in his gross income for 1963 under section 951(a)(1)(A)(i). However, of the $50 investment of earnings in United States property made by R Corporation during 1964, $35 is excludable from A's gross income for 1964 under section 959(a)(2) because such amount represents earnings and profits attributable to amounts which have been included in A's gross income for 1963 under section 951(a)(1)(A)(i). The remaining $15 is includible in A's gross income for 1964 under section 951(a)(1)(B).

(d) *Application of exclusions to shareholder's successor in interest.* If a United States person (as defined in § 1.957-4) acquires from any person any portion of the interest in the foreign corporation of a United States shareholder referred to in paragraph (b) or (c) of this section, the rules of such paragraph shall apply to such acquiring person but only to the extent that the acquiring person establishes to the satisfaction of the district director his right to the exclusion provided by such paragraph. The information to be furnished by the acquiring person to the district director with his return for the taxable year to support such exclusion shall include:

(1) The name, address, and taxable year of the foreign corporation from

which the distribution is received and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(2) The name and address of the person from whom the stock interest was acquired;

(3) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(4) The amount for which an exclusion under section 959(a) is claimed; and

(5) Evidence showing that the earnings and profits for which an exclusion is claimed are attributable to amounts which were included in the gross income of a United States shareholder under section 951(a), that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder including such amounts.

The acquiring person shall also furnish to the district director such other information as may be required by the district director in support of the exclusion.

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of R Corporation, a corporation organized on January 1, 1964, and a controlled foreign corporation throughout the period here involved. Both A and R Corporation use the calendar year as a taxable year.

(b) During 1964, R Corporation has $100 of subpart F income and earnings and profits in excess of $100. A includes $100 in his gross income for 1964 under section 951(a)(1)(A)(i). During 1965, A sells 40 percent of his stock in R Corporation to B, a United States person who uses the calendar year as a taxable year. In 1965, R Corporation has no earnings and profits and experiences no increase in earnings invested in United States property. Corporation R distributes $40 to B on December 1, 1965. If B establishes his right to the exclusion to the satisfaction of the district director, he may exclude $40 from his gross income for 1965 under section 959(a)(1).

(c) If, instead of selling his 40-percent interest directly to B, A sells on February 1, 1965, 40 percent of his stock in R Corporation to C, a nonresident alien, and on October 1, 1965, B acquires the 40-percent interest in R Corporation from C, the result is the same as in paragrapn (b) of this example, if B establishes his right to the exclusion to the satisfaction of the district director.

(d) If, instead of acquiring 40 percent, B acquires only 5 percent of A's stock in R Corporation and R Corporation distributes $5 to B during 1965, B is not a United States shareholder (within the meaning of section 951(b)) with respect to R Corporation since he owns only 5 percent of the stock of R Corporation. Notwithstanding, B may exclude the $5 distribution from his gross income for 1965 under section 959(a)(1) if he establishes his right to the exclusion to the satisfaction of the district director.

(e) If the facts are assumed to be the same as in paragraphs (a) and (b) of this example except that—

(1) A owns the stock of R Corporation indirectly through a chain of ownership described in section 958(a), that is, A owns 100 percent of M Corporation which owns 100 percent of N Corporation which owns 100 percent of R Corporation,

(2) B acquires from N Corporation 40 percent of the stock in R Corporation,

(3) Both M Corporation and N Corporation are controlled foreign corporations which use the calendar year as a taxable year,

(4) Neither M Corporation nor N Corporation has any amount in 1964 or 1965 which is includible in gross income of United States shareholders under section 951(a), and

(5) Neither M Corporation nor N Corporation has a deficit in earnings and profits for 1964;

the result is the same as in paragraph (b) of this example if B establishes his right to the exclusion to the satisfaction of the district director.

[T.D. 6795, 30 FR 943, Jan. 29, 1965]

§ 1.959-2 Exclusion from gross income of controlled foreign corporations of previously taxed earnings and profits.

(a) *Applicable rule.* The earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder. See section 959(b). The exclusion from the income of such other foreign corporation also applies with respect to any other United States shareholder who acquires from such United States shareholder or any other person any portion of the interest of such United States shareholder in the controlled foreign corporation, but only to the extent the acquiring shareholder establishes to the satisfaction of the district director his right to such exclusion. An acquiring shareholder claiming the exclusion under section 959(b) shall furnish to the district director with his return for the taxable year the information required under paragraph (d) of § 1.959-1 to support the exclusion under this paragraph.

(b) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) A, a United States shareholder, owns 100 percent of the only class of stock of M Corporation which in turn owns 100 percent of the only class of stock of N Corporation. A and corporations M and N use the calendar year as a taxable year and corporations M and N are controlled foreign corporations throughout the period here involved.

(b) During 1963, N Corporation invests $100 in tangible property (other than property described in section 956(b)(2)) located in the United States and has earnings and profits in excess of $100. A is required to include $100 in his gross income for 1963 under section 951(a)(1)(B) by reason of his indirect ownership of the stock of N Corporation. During 1963, M Corporation has no income or investments other than the income derived from a distribution of $100 from N Corporation. Corporation M has earnings and profits of $100 for 1963. Under paragraph (a) of § 1.954-2, the $100 distribution received by M Corporation from N Corporation would otherwise constitute subpart F income of M Corporation; however, by reason of section 959(b) and this section, this amount does not constitute gross income of M Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(A)(i).

(c) During 1964, N Corporation derives $100 of subpart F income and distributes $100 to M Corporation which has no subpart F income for 1964 but which invests the $100 distribution in tangible property (other than property described in section 956(b)(2)) located in the United States. Corporation N's earnings and profits for 1964 are in excess of $100, and M Corporation's current and accumulated earnings and profits (before taking into account distributions made during 1964) are in excess of $100. A is required with respect to N Corporation to include $100 in his gross income for 1964 under section 951(a)(1)(A)(i) by reason of his indirect ownership of the stock of N Corporation. The investment by M Corporation in United States property would otherwise constitute an investment of earnings in United States property to which section 956 applies; however, by reason of section 959(b) and this section, such amount does not constitute gross income of M Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(B).

(d) If during 1965, N Corporation invests $100 in tangible property (other than property described in section 956(b)(2)) located in the United States and has earnings and profits in excess of $100, A will be required with respect to N Corporation to include $100 in his gross income for 1965 under section 951(a)(1)(B), because the $100 of earnings and profits for 1964 attributable to N Corporation's subpart F income which was taxed to A in 1964 was distributed to M Corporation in such year.

(e) If, with respect to 1966—

(1) Corporation N owns 100 percent of the only class of stock of R Corporation,

(2) Corporation R derives $100 of subpart F income, has earnings and profits in excess of $100, and makes no distributions to N Corporation,

(3) Corporation N invests $25 in tangible property (other than property described in section 956(b)(2)) located in the United States and has current and accumulated earnings and profits in excess of $25, and

(4) Corporation M has no income or investments and does not have a deficit in earnings and profits,

the $100 of subpart F income derived by R Corporation is includible in A's gross income for 1966 under section 951(a)(1)(A)(i) and the $25 investment of earnings in United States property by N Corporation is includible in A's gross income for 1966 under section 951(a)(1)(B).

(f) If, however, the facts are the same as in paragraph (e) of this example except that—

(1) During 1966, R Corporation distributes $20 to N Corporation, and

(2) Corporation N makes no distributions during such year to M Corporation,

of the $25 investment in United States property by N Corporation, $20 is not includible in A's gross income for 1966 because such amount represents earnings and profits which are attributable to amounts included in A's gross income for such year under section 951(a)(1)(A)(i) with respect to R Corporation and which have been distributed to N

Corporation by R Corporation. By reason of section 959(B) and this section, such $20 distribution to N Corporation does not constitute gross income of N Corporation for purposes of determining amounts includible in A's gross income under section 951(a)(1)(B); however, the remaining $5 of investment of earnings in United States property by N Corporation in 1966 is includible in A's gross income for such year under section 951(a)(1)(B).

[T.D. 6795, 30 FR 944, Jan. 29, 1965]

§ 1.959-3 Allocation of distributions to earnings and profits of foreign corporations.

(a) *In general.* For purposes of §§ 1.959-1 and 1.959-2, the source of the earnings and profits from which distributions are made by a foreign corporation as between earnings and profits attributable to increases in earnings invested in United States property, previously taxed subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and other amounts shall be determined in accordance with section 959(c) and paragraphs (b) through (e) of this section.

(b) *Applicability of section 316(a).* For purposes of this section, section 316(a) shall be applied, in determining the source of distributions from the earnings and profits of a foreign corporation, by first applying section 316(a)(2) and then by applying section 316(a)(1)—

(1) First, as provided by section 959(c)(1), to earnings and profits attributable to amounts included in gross income of a United States shareholder under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2) and paragraph (c) of § 1.959-1),

(2) Secondly, as provided by section 959(c)(2), to earnings and profits attributable to amounts included in gross income of a United States shareholder under section 951(a)(1)(A) (but reduced by amounts not included in such gross income under section 951(a)(1)(B) because of the exclusion provided by section 959(a)(2) and paragraph (c) of § 1.959-1), and

(3) Finally, as provided by section 959(c)(3), to other earnings and profits. Thus, distributions shall be considered first attributable to amounts, if any, described in subparagraph (1) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), secondly to amounts, if any, described in subparagraph (2) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), and finally to the amounts, if any, described in subparagraph (3) of this paragraph (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year). See, however, paragraph (e) of § 1.963-3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) for a special rule for determination of the source of distributions counting as minimum distributions. Earnings and profits are classified as to year and as to section 959(c) amount in the year in which such amounts are included in gross income of a United States shareholder under section 951(a) and are reclassified as to section 959(c) amount in the year in which such amounts would be so included but for the provisions of section 959(a)(2); any subsequent distribution of such amounts to a higher tier in a chain of ownership described in section 958(a) does not of itself change such classifications. Earnings and profits of a foreign corporation attributable to amounts of previously excluded subpart F income withdrawn from investment in less developed countries (or from investments in export trade assets) shall be reclassified as amounts to which subparagraph (2), rather than subparagraph (3), of this paragraph applies for purposes of determining priority of distribution, and such earnings and profits shall be considered attributable to the taxable year in which the withdrawal occurs. This paragraph shall apply to distributions by one foreign corporation to another foreign corporation and by a foreign corporation to a United States person. The application of this paragraph may be illustrated by the following example:

Example. (a) M, a controlled foreign corporation is organized on January 1, 1963, and is 100-percent owned by A, a United

States shareholder. Both A and M Corporation use the calendar year as a taxable year, and M Corporation is a controlled foreign corporation throughout the period here involved. As of December 31, 1966, M Corporation's accumulated earnings and profits of $450 (before taking into account distributions made in 1966) applicable to A's interest in such corporation are classified for purposes of section 959(c) as follows:

Year	Classification of earnings and profits for purposes of sec. 959		
	(c)(1)	(c)(2)	(c)(3)
1963	$100		
1964	100	$75	
1965		75	$50
1966			50

(b) During 1966, M Corporation makes three separate distributions to A of $150 each, and the source of such distributions under section 959(c) is as follows:

	Amount	Year	Allocation of distributions under sec. 959
Distribution No. 1	$100	1964	(c)(1)
	50	1963	(c)(1)
	150		
Distribution No. 2	50	1963	(c)(1)
	75	1965	(c)(2)
	25	1964	(c)(2)
	150		
Distribution No. 3	50	1964	(c)(2)
	50	1966	(c)(3)
	50	1965	(c)(3)
	150		

(c) If, in addition to the above facts—

(1) M Corporation owns throughout the period here involved 100 percent of the only class of stock of N Corporation, a controlled foreign corporation which uses the calendar year as a taxable year,

(2) Corporation N derives $60 of subpart F income for 1963 which A includes in his gross income for such year under section 951(a)(1)(A)(i),

(3) Corporation N has earnings and profits for 1963 of $60 but has neither earnings or profits nor a deficit in earnings and profits for 1964, 1965, or 1966, and

(4) During 1966, N Corporation invests $20 in tangible property (not described in section 956(b)(2)) located in the United States and distributes $45 to M Corporation, the $20 investment of earnings in United States property is excludable from A's gross income for 1966, under section 959(a)(2) and paragraph (c) of § 1.959-1, with respect to N Corporation and the $45 dividend received by M Corporation does not, under section 959(b) and § 1.959-2, constitute gross income of M Corporation for 1966 for purposes of determining amounts includible in A's gross income under section 951(a)(1)(A)(i) with respect to M Corporation. However, the $45 dividend paid by N Corporation to M Corporation is allocated under section 959(c) and this paragraph to the earnings and profits of N Corporation as follows: $20 to 1963 earnings described in section 959(c)(1) and $25 to 1963 earnings described in section 959(c)(2). In such case, M Corporation's earnings and profits of $495 (before taking into account distributions made in 1966) would be classified as follows for purposes of section 959(c):

Year	Classification of earnings and profits for purposes of sec. 959		
	(c)(1)	(c)(2)	(c)(3)
1963	$120	$25	
1964	100	75	
1965		75	$50
1966			50

(d) The three distributions to A in 1966 of $150 each would then have the following source under section 959(c):

	Amount	Year	Allocation of distributions under sec. 959
Distribution No. 1	$100	1964	(c)(1)
	50	1963	(c)(1)
	150		
Distribution No. 2	70	1963	(c)(1)
	75	1965	(c)(2)
	5	1964	(c)(2)
	150		
Distribution No. 3	70	1964	(c)(2)
	25	1963	(c)(2)
	50	1966	(c)(3)
	5	1965	(c)(3)
	150		

(c) *Treatment of deficits in earnings and profits.* For purposes of this section, a United States shareholder's pro rata share (determined in accordance with the principles of paragraph (e) of § 1.951-1) of a foreign corporation's deficit in earnings and profits, determined under section 964(a) and § 1.964-1, for any taxable year shall be applied only to earnings and profits described in paragraph (b)(3) of this section.

(d) *Treatment of certain foreign taxes.* For purposes of this section, any amount described in subparagraph (1), (2), or (3) of paragraph (b) of this section which is distributed by a foreign corporation through a chain of ownership described in section 958(a)(2) shall be reduced by any income, war profits, or excess profits taxes imposed on or with respect to such distribution by any foreign country or possession of the United States.

Example. (a) Domestic corporation M owns 100 percent of the only class of stock of foreign corporation A, which is incorporated under the laws of foreign country X and which, in turn, owns 100 percent of the only class of stock of foreign corporation B, which is incorporated under the laws of foreign country Y. All corporations use the calendar year as a taxable year and corporations A and B are controlled foreign corporations throughout the period here involved.

(b) During 1963, B Corporation (a less developed country corporation for 1963 within the meaning of § 1.955-5) derives $90 of subpart F income, after incurring $10 of foreign income tax allocable to such income under paragraph (c) of § 1.954-1, has earnings and profits in excess of $90, and makes no distributions. Corporation M must include $90 in its gross income for 1963 under section 951(a)(1)(A)(i). As of December 31, 1963, with respect to M Corporation, B Corporation has earnings and profits for 1963 described in section 959(c)(2) of $90.

(c) During 1964, B Corporation has neither earnings and profits nor a deficit in earnings and profits but distributes $90 to A Corporation, and, by reason of section 959(b) and § 1.959-2, such amount is not includible in the gross income of M Corporation for 1964 under section 951(a) with respect to A Corporation. Corporation A incurs a withholding tax of $13.50 on the $90 dividend distributed from B Corporation (15 percent of $90) and an additional foreign income tax of 10 percent or $7.65 by reason of the inclusion of the net distribution of $76.50 ($90 minus $13.50) in its taxable income for 1964. As of December 31, 1964, with respect to M Corporation, B Corporation's earnings and profits for 1963 described in section 959(c)(2) amount to zero ($90 minus $90); and A Corporation's earnings and profits for 1963 described in section 959(c)(2) amount to $68.85 ($90 minus $13.50 minus $7.65).

(e) *Determination of foreign tax credit.* For purposes of applying section 902 and section 960 in determining the foreign tax credit allowable under section 901 in a case in which distributions are made by a second-tier corporation or a first-tier corporation, as the case may be, from its earnings and profits for a taxable year which are attributable to an amount included in the gross income of a U.S. shareholder under section 951(a) or which are attributable to amounts excluded from the gross income of such foreign corporation under section 959(b) and § 1.959-2 with respect to a U.S. shareholder, the rules of paragraph (b) of this section shall apply except that in applying subparagraph (1) or (2) of such paragraph—

(1) Distributions from the earnings and profits for such taxable year of the second-tier corporation shall be considered first attributable to its earnings and profits attributable to distributions from the earnings and profits of the foreign corporation, if any, next lower in the chain of ownership described in section 958(a), to the extent of such earnings and profits of the second-tier corporation, and then to the other earnings and profits of such second-tier corporation, and

(2) Distributions from the earnings and profits for such taxable year of the first-tier corporation shall be considered first attributable to its earnings and profits attributable to distributions from the earnings and profits of the second-tier corporation, to the extent of such earnings and profits of the first-tier corporation, and then to the other earnings and profits of such first-tier corporation. For purposes of this paragraph, a second-tier corporation is a foreign corporation referred to in section 960(a)(1)(B), and a first-tier corporation is a foreign corporation referred to in section 960 (a)(1)(A). The application of this paragraph may be illustrated by the following examples:

Example (1). (a) Domestic corporation A, a United States shareholder, owns 100 percent of the only class of stock of foreign corporation R which, in turn, owns 100 percent of the only class of stock of foreign corporation S. All corporations use the calendar year as a taxable year, and corporations R and S are controlled foreign corporations throughout the period here involved.

(b) Neither R Corporation nor S Corporation has subpart F income for 1963. During 1963, S Corporation increases by $100 its investment in tangible property (not described in section 956(b)(2)) located in the United States, makes no distributions, and has earnings and profits of $100. Corporation A must include $100 in its gross income for 1963 under section 951(a)(1)(B) with respect to S Corporation. During 1963, R Corporation also increases by $100 its investment in tangible property (not described in section 956(b)(2)) located in the United States, makes no distributions, and has earnings and profits of $100. Corporation A must include $100 in its gross income for 1963 under section 951(a)(1)(B) with respect to R Corporation.

(c) During 1964, S Corporation distributes $100 to R Corporation, and R Corporation distributes $100 to A Corporation. Neither corporation has any earnings or profits or deficit in earnings and profits for such year. On December 31, 1964, R Corporation has earnings and profits (computed before distributions to A Corporation made for the year) of $200, consisting of $100 of section 959(c)(1) amounts of R Corporation for 1963 and of $100 of section 959(c)(1) amounts of S Corporation for 1963. For purposes of determining the foreign tax credit under section 960 and the regulations thereunder, the $100 distribution by R Corporation shall be considered attributable to S Corporation's earnings and profits for 1963 described in section 959(c)(1).

Example (2). (a) Domestic corporation A, a United States shareholder, owns 100 percent of the only class of stock of foreign corporation T which, in turn, owns 100 percent of the only class of stock of foreign corporation U. All corporations use the calendar year as a taxable year, and corporations T and U are controlled foreign corporations throughout the period here involved.

(b) During 1964, T Corporation invests $100 in tangible property (not described in section 956(b)(2)) located in the United States. For 1964, T Corporation has no subpart F income and makes no distributions; A must include $100 in its gross income for 1964 under section 951(a)(1)(B) with respect to T Corporation. For 1964, U Corporation has no subpart F income or investment of earnings in United States property but U Corporation has $100 of earnings and profits which it distributes to T Corporation. At December 31, 1964, T Corporation has earnings and profits of $300, consisting of operating income of $100 for each of the years 1963 and 1964 and $100 in dividends received from the earnings and profits of U Corporation for 1964. These earnings and profits are classified as follows under section 959(c): $100 of section 959(c)(1) amounts of T Corporation for 1964, $100 of section 959(c)(3) amounts of U Corporation for 1964, and $100 of section 959(c)(3) amounts of T Corporation for 1963.

(c) During 1965 neither T Corporation nor U Corporation has any earnings and profits or deficit in earnings and profits or investment of earnings in U.S. property, but T Corporation distributes $100 to A Corporation. For purposes of determining the foreign tax credit under section 960 and the regulations thereunder, the $100 distribution of T Corporation shall be considered attributable to T Corporation's earnings and profits for 1964 described in section 959(c)(1).

(f) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) M, a controlled foreign corporation is organized on January 1, 1963, and is wholly owned by A, a United States shareholder. Both A and Corporation M use the calendar year as a taxable year.

(b) Corporation M's earnings and profits (before distributions) for 1963 are $200, $100, of which is attributable to subpart F income. Corporation M's earnings and profits for such year also include $25 attributable to subpart F income which is excluded from M Corporation's foreign base company income under section 954(b)(1) as dividends, interest, and gains invested in qualified investments in less developed countries. Corporation M's increase in earnings invested in tangible property (not described in section 956(b)(2)) located in the United States for 1963, is $50, and M Corporation makes a distribution of such property during such year of $20. For purposes of section 959, A's interest in M Corporation's earnings and profits as of December 31, 1963, determined after the distributions of $20, is classified as follows:

Sec. 959(c)(1) amounts:		
Earnings for 1963 attributable to increased investment in U.S. property which would have been included in A's gross income but for application of sec. 959(a)(2) and § 1.959-1(c)	$50	
Less: Distribution for 1963 allocated under sec. 959(c)(1) and paragraph (b)(1) of this section to such amounts	20	$30

Sec. 959(c)(2) amounts:			
Earnings for 1963 attributable to subpart F income included in A's gross income under sec. 951(a)(1)(A)(i)		100	
Less: Earnings for 1963 attributable to increased investment in U.S. property which would have been included in A's gross income but for application of sec. 959(a)(2) and § 1.959-1(c)		50	50
Sec. 959(c)(3) amounts:			
Predistribution earnings for 1963		200	
Less: Earnings for 1963 classified as:			
Sec. 959(c)(1) amounts	$50		
Sec. 959(c)(2) amounts	50	100	100
A's total interest in M Corporation's earnings and profits			180

For 1963, A is required to include $100 of subpart F income in his gross income under section 951(a)(1)(A)(i). He would have been required to include $50 in his gross income under section 951(a)(1)(B) as M Corporation's increase in earnings invested in United States property, except that section 959(a)(2) and paragraph (c) of § 1.959-1 provide in effect that earnings and profits taxed to A under section 951(a)(1)(A) with respect to M Corporation (whether in the current taxable year or in prior years) may be invested in United States property without again being included in gross income under section 951(a). The $20 dividend from M Corporation is excluded from A's gross income under section 959(a)(1) and paragraph (b) of § 1.959-1, since such distribution is allocated under section 959(c)(1) and paragraph (b)(1) of this section to amounts described in section 959(c)(1).

(c) During 1964, M Corporation's earnings and profits (before distributions) are $300, $75 of which is attributable to subpart F income. Corporation M has no change in investments in United States property during such year and withdraws $15 of previously excluded subpart F income from investment in less developed countries. Corporation M makes a cash distribution of $250 to A during 1964. For purposes of section 959, A's interest in M Corporation's earnings and profits as of December 31, 1964, determined after the distribution of $250, is classified as follows:

Sec. 959 (c)(1) amounts:				
Sec. 959(c)(1) net amount for 1963 (as determined under paragraph (b) of this example)			$30	
Less: Distribution for 1964 allocated under sec. 959(c)(1) and paragraph (b)(1) of this section to such amount			30	
Sec. 959(c)(2) amounts:				
Sec. 959(c)(2) net amount for 1963 (as determined under paragraph (b) of this example)			50	
Plus: Earnings for 1964 attributable to:				
Subpart F income for 1964 included in A's gross income under sec. 951(a)(1)(A)(i)			75	
Previously excluded subpart F income withdrawn in 1964 from investment in less developed countries and included in A's gross income under sec. 951(a)(1)(A)(ii)			15	
			140	
Less: Distribution for 1964 allocated under sec. 959(c)(2) and paragraph (b)(2) of this section to such amounts			140	
Sec. 959(c)(3) amounts:				
Sec. 959(c)(3) net amount for 1963 (as determined under paragraph (b) of this example)			100	
Plus: Sec. 959(c)(3) net amount for 1964:				
Predistribution earnings for 1964		$300		
Less:				
Earnings for 1964 classified as sec. 959(c)(1) amounts ($0) and as sec. 959(c)(2) amounts ($75+$15)	$90			
Distributions for 1964 allocated under sec. 959(c)(3) and paragraph (b)(3) of this section	80	170	130	$230
A's total interest in M Corporation's earnings and profits				230

For 1964, A is required to include in his gross income under section 951(a)(1)(A)(i) $75 of subpart F income, and under section 951 (a)(1)(A)(ii) $15 of previously excluded subpart F income withdrawn from investment in less developed countries. Of the $250 cash distribution, A may exclude $170 from his gross income under section 959(a)(1) and paragraph (b) of § 1.959-1 and $80 is includible in his gross income as a dividend.

(d) The source under section 959(c) of the 1964 distribution of $250 to A is as follows:

Year	Amount	Allocation of distribution under sec. 959
1963	30	(c)(1).
1964	90	(c)(2).
1963	50	(c)(2).
1964	80	(c)(3).
	250	

[T.D. 6795, 30 FR 945, Jan. 29, 1965, as amended at T.D. 7334, 39 FR 44211, Dec. 23, 1974; T. D. 7545, 43 FR 19652, May 8, 1978]

§ 1.959-4 Distributions to United States persons not counting as dividends.

Except as provided in section 960(a)(3) and § 1.960-2, any distribution to a United States person which is excluded from the gross income of such person under section 959(a)(1) and § 1.959-1 shall be treated for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code as a distribution which is not a dividend. However, see paragraph (b)(1) of § 1.956-1, relating to the dividend limitation on the amount of a controlled foreign corporation's investment of earnings in United States property.

[T.D. 7120, 36 FR 10860, June 4, 1971]

§ 1.960-1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

(a) *Scope of regulations under section 960.* This section prescribes rules for determining the foreign income taxes deemed paid under section 960(a)(1) by a domestic corporation which is required under section 951 to include in gross income an amount attributable to a first-tier or second-tier corporation's earnings and profits. Section 1.960-2 prescribes rules for applying section 902 to dividends paid by a second-tier corporation or a first-tier corporation from earnings and profits attributable to an amount which is, or has been, included in gross income under section 951. Section 1.960-3 provides special rules for the application of the gross-up provisions of section 78 where an amount is included in gross income under section 951. Section 1.960-4 prescribes rules for increasing the applicable foreign tax credit limitation under section 904(a) of the domestic corporation for the taxable year in which it receives a distribution of earnings and profits in respect of which it was required under section 951 to include an amount in its gross income for a prior taxable year. Section 1.960-5 prescribes rules for disallowing a deduction for foreign income taxes for such taxable year of receipt where the domestic corporation received the benefits of the foreign tax credit for such previous taxable year of inclusion. Section 1.960-6 provides that the excess of such an increase in the applicable limitation under section 904(a) over the tax liability of the domestic corporation for such taxable year of receipt results in an overpayment of tax.

(b) *Definitions.* For purposes of section 960 and §§ 1.960-1 through 1.960-6—

(1) *First-tier corporation.* The term "first-tier corporation" means a foreign corporation at least 10 percent of the voting stock of which is owned by the domestic corporation described in paragraph (a) of this section.

(2) *Second-tier corporation.* The term "second-tier corporation" means a foreign corporation at least 50 percent of the voting stock of which is owned by such first-tier corporation.

(3) *Foreign income taxes.* The term "foreign income taxes" means income, war profits, and excess profits taxes, and taxes included in the term "income, war profits, and excess profits taxes" by reason of section 903, imposed by a foreign country or a possession of the United States.

(c) *Amount of foreign income taxes deemed paid by domestic corporation in respect of earnings and profits of foreign corporation attributable to amount included in income under section 951*— (1) *In general.* For purposes of section 901—

(i) If for the taxable year there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a first-tier corporation for any taxable year, such domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid, accrued, or deemed (in accordance with paragraph (b) of § 1.960–2) to be paid, by such first-tier corporation on or with respect to the earnings and profits of such first-tier corporation for its taxable year as the amount so included in the gross income of the domestic corporation under section 951 with respect to such first-tier corporation bears to the total earnings and profits of such first-tier corporation for its taxable year.

(ii) If for the taxable year there is included in the gross income of a domestic corporation under section 951 an amount attributable to the earnings and profits of a second-tier corporation for any taxable year, such domestic corporation shall be deemed to have paid the same proportion of the total foreign income taxes paid or accrued by such second-tier corporation on or with respect to the earnings and profits of such second-tier corporation for its taxable year as the amount (determined without regard to section 958(a)(2)) so included in the gross income of the domestic corporation under section 951 with respect to such second-tier corporation bears to the total earnings and profits of such second-tier corporation.

(iii) In applying subdivision (i) of this subparagraph to a first-tier corporation which for the taxable year has income excluded under section 959(b), subparagraph (3) of this paragraph shall apply for purposes of excluding certain earnings and profits of such corporation and foreign income taxes, if any, attributable to such excluded income.

(iv) This subparagraph applies whether or not the first-tier corporation or the second-tier corporation makes a distribution for the taxable year of its earnings and profits which are attributable to the amount included in the gross income of the domestic corporation under section 951.

(v) This subparagraph does not apply to an increase in current earnings invested in United States property which, but for paragraph (e) of § 1.963–3 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) would be included in the gross income of the domestic corporation under section 951(a)(1)(B) but which, pursuant to such paragraph, counts toward a minimum distribution for the taxable year.

(2) *Taxes paid or accrued on or with respect to earnings and profits of foreign corporation.* For purposes of subparagraph (1) of this paragraph, the foreign income taxes paid or accrued by a first-tier corporation or its second-tier corporation, as the case may be, on or with respect to its earnings and profits for its taxable year shall be the total amount of the foreign income taxes paid or accrued by such foreign corporation for such taxable year.

(3) *Exclusion of earnings and profits and taxes of first-tier corporation having income excluded under section 959(b).* If in the case of a first-tier corporation to which subparagraph (1)(i) of this paragraph is applied—

(i) The earnings and profits of such first-tier corporation for its taxable year consist of (*a*) earnings and profits attributable to dividends received from a second-tier corporation to which, in accordance with paragraph (b) of § 1.960–2, section 902(b) does not apply and (*b*) other earnings and profits, and

(ii) The effective rate of foreign income taxes paid or accrued by such first-tier corporation in respect to the dividends to which its earnings and profits described in subdivision (i) (*a*) of this subparagraph are attributable is higher or lower than the effective rate of foreign income taxes paid or accrued by such first-tier corporation in respect to the income to which its earnings and profits described in subdivision (i) (*b*) of this subparagraph are attributable, then, for purposes of applying subparagraph (1)(i) of this paragraph to the foreign income taxes paid, accrued, or deemed to be paid, by such first-tier corporation on or with respect to its earnings and profits for such taxable year, the earnings and profits of such first-tier corporation for such taxable year shall be considered not to include the earnings and profits described in subdivision (i) (*a*) of this subparagraph and only the foreign income taxes paid, accrued, or deemed to be paid, by such first-tier corporation in respect to the income to which its earnings and profits described in subdivision (i) (*b*) of this subparagraph are attributable shall be taken into account. For purposes of applying this subparagraph, the effective rate of foreign income taxes paid or accrued in respect to income shall be determined consistently with the principles of paragraphs (b)(3) (iv) and (viii) and (c) of § 1.954–1. Thus, for example, the effective rate of foreign income taxes paid or accrued in respect to dividends received by such first-tier corporation shall be determined by taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $50 attributable to the earnings and profits of A Corporation for such year, but A Corporation does not distribute any earnings and profits for such year. The foreign income taxes paid by A Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

Pretax earnings and profits of A Corporation	$100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income under sec. 951	50.00
Dividends paid to N Corporation	0
Foreign income taxes paid on or with respect to earnings and profits of A Corporation	20.00
Foreign income taxes of A Corporation deemed paid by N Corporation under sec. 960(a)(1) ($50/$80×$20)	12.50

Example (2). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $45 attributable to the earnings and profits of B Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation for such year. Neither B Corporation nor A Corporation distributes any earnings and profits for 1978. The foreign income taxes paid by B Corporation for 1978 which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

Pretax earnings and profits of B Corporation	$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amounts required to be included in N Corporation's gross income under sec. 951 with respect to B Corporation	45.00
Dividends paid	0
Foreign income taxes paid on or with respect to earnings and profits of B Corporation	40.00
Foreign income taxes of B Corporation deemed paid by N Corporation under sec. 960(a)(1) ($45/$60×$40)	30.00

Example (3). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns 25 percent of the one class of stock of controlled foreign corporation B. N Corporation also directly owns 75 percent of the one class of stock of B Corporation. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $60 attributable to the earnings and profits of B Corporation and $76 attributable to the earnings and profits of A Corporation. For 1978, B Corporation distributes $15 to N Corporation and $5 to A Corporation, but A Corporation makes no distribution to N Corporation. The foreign income taxes paid by corporations A and B which are deemed paid by N Corporation for such year under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):	
Pretax earnings and profits	$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Amount required to be included in N Corporation's gross income under sec. 951 with respect to B Corporation	60.00
A Corporation (first-tier corporation):	
Pretax earnings and profits (including $5 dividend from B Corporation)	100.00
Foreign income taxes (20%)	20.00
Earnings and profits	80.00
Amount required to be included in N Corporation's gross income with respect to A Corporation ($95—[$95×0.20])	76.00
N Corporation (domestic corporation):	
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1)(C) with respect to—	
B Corporation ([$60×0.75]/$60×$40)	30.00
A Corporation ($76/$80×$20)	19.00
Total taxes deemed paid under sec. 960(a)(1)	49.00

Example (4). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $175 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation has earnings and profits of $225, on which it pays foreign income taxes of $75. In 1978, B Corporation distributes $150, which, under paragraph (b) of § 1.960–2, consists of $100 to which section 902(b) does not apply (from B Corporation's earnings and profits attributable to an amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation) and $50 to which section 902(b)(1) applies (from B Corporation's other earnings and profits). The country under the laws of which A Corporation is incorporated imposes an income tax of 40 percent on all income but exempts from tax dividends received from a subsidiary corporation. A Corporation makes no distribution for 1978. Under paragraph (b) of § 1.960–2, A Corporation is deemed to have paid $25 ($50/$150×$75) of the $75 foreign income taxes paid by B Corporation on its pretax earnings and profits of $225. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) with respect to A Corporation are determined as follows upon the basis of the following assumed facts:

Pretax earnings and profits of A Corporation:			
Dividends received from B Corporation		$150.00	
Other income		250.00	
Total pretax earnings and profits			$400.00
Foreign income taxes:			
On dividends received from B Corporation		none	
On other income ($250×0.40)		100.00	
Total foreign income taxes			100.00
Earnings and profits:			
Attributable to dividends received from B Corporation to which sec. 902(b) does not apply		100.00	
Attributable to other income:			
Attributable to dividends received from B Corporation to which sec. 902(b)(1) applies	$50.00		
Attributable to other income ($250 − $100[$250 × 0.40])	150.00	200.00	
Total earnings and profits			300.00
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1) with respect to A Corporation:			
Tax paid by A Corporation in respect to its income other than dividends received from B Corporation to which sec. 902(b) does not apply ($175/$200 × $100)			87.50
Tax of B Corporation deemed paid by A Corporation under sec. 902(b)(1) in respect to such income ($175/$200 × $25)			21.88
Total foreign income taxes deemed paid by N Corporation under sec. 960(a)(1) with respect to A Corporation			109.38

(d) *Time for stock ownership*—(1) *First-tier corporation.* The 10-percent stock ownership requirement referred to in paragraph (b)(1) of this section with respect to a first-tier corporation having earnings and profits for its taxable year in respect of which an amount is included under section 951 in the gross income for the taxable year of a domestic corporation must be satisfied on the last day in such taxable year of such first-tier corporation on which such first-tier corporation is a controlled foreign corporation.

(2) *Second-tier corporation.* Both the 10-percent and the 50-percent stock ownership requirements referred to in paragraph (b) (1) and (2) of this section with respect to a second-tier corporation having earnings and profits for its taxable year in respect of which an amount is included under section 951 in the gross income for the taxable year of a domestic corporation must be satisfied on the last day in such taxable year of such second-tier corporation on which such second-tier corporation is a controlled foreign corporation, whether or not the first-tier corporation is a controlled foreign corporation on such day.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Domestic corporation N is required for its taxable year ending June 30, 1964, to include in gross income under section 951 an amount attributable to the earnings and profits of controlled foreign corporation A for 1963 and another amount attributable to the earnings and profits of controlled foreign corporation B for such year. Corporations A and B use the calendar year as the taxable year. Such amounts are required to be included in N Corporation's gross income by reason of its ownership of stock in A Corporation and in turn by A Corporation's ownership of stock in B Corporation. Corporation A is a controlled foreign corporation throughout 1963, but B Corporation is a controlled foreign corporation only from January 1, 1963, through September 30, 1963. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1964, for foreign income taxes paid by A Corporation for

1963, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on December 31, 1963. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1964, for foreign income taxes paid by B Corporation for 1963, only if on September 30, 1963, N Corporation owns at least 10 percent of the voting stock of A Corporation and A Corporation owns at least 50 percent of the voting stock of B Corporation.

Example (2). The facts are the same as in example (1) except that A Corporation is a controlled foreign corporation only from January 1, 1963, through March 31, 1963. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1964, for foreign income taxes paid by A Corporation for 1963, only if N Corporation owns at least 10 percent of the voting stock of A Corporation on March 31, 1963. Corporation N may obtain credit under section 960(a)(1) for the year ending June 30, 1964, for foreign income taxes paid by B Corporation for 1963, only if on September 30, 1963, N Corporation owns at least 10 percent of the voting stock of A Corporation and A Corporation owns at least 50 percent of the voting stock of B Corporation.

(e) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes taxes deemed paid under section 960(a)(1), the domestic corporation must furnish the same information with respect to the taxes so deemed paid as it is required to furnish with respect to the taxes actually paid or accrued by it and for which credit is claimed. See § 1.905-2. For other information required to be furnished by the domestic corporation for the annual accounting period of certain foreign corporations ending with or within such corporation's taxable year, see section 6038 and § 1.6038-2.

(f) *Reduction of foreign income taxes paid or deemed paid.* For reduction of the amount of foreign income taxes paid or deemed paid by a foreign corporation for purposes of section 960, see section 6038(b) and the regulations thereunder, relating to failure to furnish information with respect to certain foreign corporations.

(g) *Amounts under section 951 treated as distributions for purposes of applying effective dates.* For purposes of applying section 902 in determining the amount of credit allowed under section 960(a)(1) and paragraph (c) of this section, the effective date provisions of the regulations under section 902 shall apply, and for purposes of so applying the regulations under section 902 any amount attributable to the earnings and profits for the taxable year of a first-tier corporation which is included in the gross income of a domestic corporation under section 951 shall be treated as a distribution received by such domestic corporation on the last day in such taxable year on which such first-tier corporation is a controlled foreign corporation.

(h) *Source of income and country to which tax is deemed paid*—(1) *Source of income.* For purposes of section 904—

(i) The amount included in gross income of a domestic corporation under section 951 for the taxable year with respect to a first-tier corporation or a second-tier corporation, plus

(ii) Any section 78 dividend to which such section 951 amount gives rise by reason of taxes deemed paid by such domestic corporation under section 960(a)(1),

shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation of such second-tier corporation, is created or organized.

(2) *Country to which taxes deemed paid.* For purposes of section 904, the foreign income taxes paid by the first-tier corporation or the second-tier corporation and deemed to be paid by the domestic corporation under section 960(a)(1) by reason of the inclusion of the amount described in subparagraph (1)(i) of this paragraph in the gross income of such domestic corporation shall be deemed to be paid to the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation of such second-tier corporation, is created or organized.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following example:

Example. Domestic corporation N owns all the one class of stock of controlled foreign corporation A, incorporated under the laws of foreign country X, which owns all the one class of stock of controlled foreign corporation B, incorporated under the laws of foreign country Y. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $45 attributable to the earnings and profits of B Corporation for such year and $50 attributable to the earnings and profits of A Corporation for such year. For 1978, because of the inclusion of such amounts in gross income, N Corporation is deemed under section 960(a)(1) and paragraph (c) of this section to have paid $15 of foreign income taxes paid by B Corporation for such year and $10 of foreign income taxes paid by A Corporation for such year. For purposes of section 904, the amount ($95) included in N Corporation's gross income under section 951 attributable to the earnings and profits of Corporations A and B is deemed to be derived from sources within country X, and the section 78 dividend consisting of the foreign income taxes ($25) deemed paid by N Corporation under section 960(a)(1) with respect to such $95 is deemed to be derived from sources within country X. The $25 of foreign income taxes so deemed paid by N Corporation are deemed to be paid to country X for purposes of section 904.

[T.D. 7120, 36 FR 10852, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44211, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7649, 44 FR 60088, 60089, Oct. 18, 1979]

§ 1.960-2 Interrelation of section 902 and section 960 when dividends are paid by second-tier corporation or by first-tier corporation.

(a) *Scope of this section.* This section prescribes rules for the application of section 902 in a case where dividends are paid by a second-tier corporation or a first-tier corporation, as the case may be, from the earnings and profits for a taxable year when an amount attributable to such earnings and profits is included in the gross income of a domestic corporation under section 951 or when such earnings and profits are attributable to an amount excluded from the gross income of such foreign corporation under section 959(b) and § 1.959-2 with respect to the domestic corporation. In making determinations under this section, any portion of a distribution received from a first-tier corporation by the domestic corporation which is excluded from the domestic corporation's gross income under section 959(a) and § 1.959-1 shall be treated as a dividend for purposes of taking into account under section 902 any foreign income taxes which are not deemed paid by the domestic corporation under section 960(a)(1) and § 1.960-1. For purposes of this section, earnings and profits of a first-tier corporation or a second-tier corporation attributable to an increase in current earnings invested in United States property which, pursuant to paragraph (e) of § 1.963-3, count toward a minimum distribution for the taxable year shall not be treated as being attributable to an amount which is, or has been, included in the gross income of a domestic corporation under section 951.

(b) *Application of section 902(b) to dividends received by first-tier corporation from second-tier corporation.* For purposes of paragraph (a) of this section and paragraph (c)(1)(i) of § 1.960-1, section 902(b) shall apply to all dividends received by the first-tier corporation for its taxable year from the second-tier corporation other than dividends attributable to earnings and profits of such second-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such second-tier corporation.

(c) *Application of section 902(a) to dividends received by domestic corporation from first-tier corporation*—(1) *In general.* For purposes of paragraph (a) of this section, section 902(a) shall apply to all dividends received by the domestic corporation for its taxable year from the first-tier corporation other than dividends attributable to earnings and profits of such first-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such first-tier corporation.

(2) *Separate determinations under section 902(a) in case of first-tier corporation having income excluded under section 959(b).* If in the case of a first-tier corporation to which subparagraph (1) of this paragraph is applied—

(i) The earnings and profits of such first-tier corporation for its taxable year consist of (*a*) earnings and profits attributable to dividends received from a second-tier corporation to which, in accordance with paragraph (b) of this section, section 902(b) does not apply and (*b*) other earnings and profits, and

(ii) The effective rate of foreign income taxes paid or accrued by such first-tier corporation in respect to the dividends to which its earnings and profits described in subdivision (i)(*a*) of this subparagraph are attributable is higher or lower than the effective rate of foreign income taxes paid or accrued by such first-tier corporation in respect to the income to which its earnings and profits described in subdivision (i)(*b*) of this subparagraph are attributable, then, for purposes of applying subparagraph (1) of this paragraph to dividends received by the domestic corporation from the first-tier corporation, section 902(a) shall be applied separately to the portion of the dividends which is attributable to the earnings and profits described in subdivision (i)(*a*) of this subparagraph and separately to the portion of the dividends which is attributable to the earnings and profits described in subdivision (i)(*b*) of this subparagraph. For this purpose, in making each such separate determination, only the foreign income taxes paid, accrued, or, in the case of earnings and profits described in subdivision (i)(*b*) of this subparagraph, deemed to be paid, by such first-tier corporation in respect to the income to which the earnings and profits are attributable in respect of which the separate determination is being made shall be taken into account. For purposes of applying this subparagraph, no part of the foreign income taxes paid, accrued, or deemed to be paid, by such first-tier corporation for such taxable year in respect to the income to which its earnings and profits described in subdivision (i)(*b*) of this subparagraph are attributable shall be attributed to its earnings and profits described in subdivision (i)(*a*) of this subparagraph; and no part of the foreign income taxes paid or accrued by such first-tier corporation for such taxable year in respect to the dividends to which its earnings and profits described in subdivision (i)(*a*) of this subparagraph are attributable shall be attributed to its earnings and profits described in subdivision (i)(*b*) of this subparagraph. Furthermore, the effective rate of foreign income taxes paid or accured in respect to income shall be determined consistently with the principles of paragraphs (b)(3) (iv) and (viii) and (c) of § 1.954-1. Thus, for example, the effective rate of foreign income taxes paid or accrued in respect to dividends received by such first-tier corporation shall be determined by taking into account any intercorporate dividends received deduction allowed to such corporation for such dividends.

(d) *Allocation of earnings and profits of first-tier corporation having income excluded under section 959(b).* If the first-tier corporation for its taxable year receives from the second-tier corporation dividends to which, in accordance with paragraph (b) of this section, section 902(b) applies and other dividends to which section 902(b) does not apply, then in applying section 902(a) pursuant to this section, and in applying section 960(a)(1) pursuant to paragraph (c)(1)(i) of § 1.960-1, with respect to the foreign income taxes deemed paid by such first-tier corporation for such taxable year under section 902(b)—

(1) The earnings and profits of the first-tier corporation for such taxable year shall be considered not to include its earnings and profits which are attributable to such other dividends from the second-tier corporation, and

(2) For purposes of so applying section 902(a), distributions to the domestic corporation from such earnings and profits which are attributable to such other dividends from the second-tier corporation shall not be treated as a dividend.

(e) *Illustrations.* The application of this section may be illustrated by the following examples, in all of which, other than examples (6) and (7), it is assumed that the effective rate of foreign income taxes paid or accrued by the first-tier corporation in respect to dividends received from the second-tier corporation is the same as the effective rate of foreign income taxes paid or accrued by the first-tier corporation in respect to its other income:

Example (1). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $50 in gross income attributable to the earnings and profits of A Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of B Corporation. For such year, B Corporation distributes a dividend of $45, but A Corporation does not make any distributions. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1), after applying section 902(b)(1) for such year of A Corporation, are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$100.00
Foreign income taxes (40%)		40.00
Earnings and profits		60.00
Dividends paid to A Corporation		45.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		40.00
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under sec. 902(b)(1) ($45/$60 × $40)		30.00
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends from B Corporation	$45.00	
Other income	100.00	
Total pretax earnings and profits		145.00
Foreign income taxes (20%)		29.00
Earnings and profits		116.00
Foreign income taxes paid, and deemed to be paid, by A Corporation on or with respect to its earnings and profits ($29 + $30)		59.00
Amount required to be included in N Corporation's gross income under sec. 951 with respect to A Corporation		50.00
Dividends paid to N Corporation		0
N Corporation (domestic corporation):		
Foreign income taxes of A Corporation deemed paid by N Corporation for 1978 under sec. 960(a)(1) ($50/$116 × $59)		25.43

Example (2). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year, which B Corporation distributes during such year. Corporation N is not required for 1978 to include any amount in gross income under section 951 attributable to the earnings and profits of A Corporation, but A Corporation distributes for such year $135 from its earnings and profits attributable to B Corporation's dividend. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1)(C) and section 902(a) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20%)		50.00
Earnings and profits		200.00
Amounts required to be included in N Corporation's gross income under sec. 951 with respect to B Corporation		150.00
Dividends paid to A Corporation		150.00
Foreign income taxes paid on or with respect to earnings and profits of B Corporation		50.00
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends from B Corporation	$150.00	
Other income	200.00	
Total pretax earnings and profits		$350.00
Foreign income taxes (10%)		35.00
Earnings and profits		315.00
Dividends paid to N Corporation		135.00
Foreign income taxes paid by A Corporation on or with respect to its accumulated profits		35.00
N Corporation (domestic corporation):		
Foreign income taxes of B Corporation deemed paid by N Corporation for 1978 under sec. 960(a)(1) ($150/$200 × $50)		37.50
Foreign income taxes of A Corporation deemed paid by N Corporation for 1978 under sec. 902(a) ($135/$315 × $35)		15.00
Total foreign income taxes deemed paid by N Corporation under sec. 901		52.50

Example (3). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include $180 in gross income attributable to the earnings and profits of A Corporation for such year, but is not required to include any amount in gross income under section 951 attributable to the earnings and profits of B Corporation. Corporation B distributes from its earnings and profits for 1978 a dividend of $50. For 1978, A Corporation distributes $180 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income for such year with respect to A Corporation and $20 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):	
Pretax earnings and profits	$100.00
Foreign income taxes (40%)	40.00
Earnings and profits	60.00
Dividends paid to A Corporation	50.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits	40.00

Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under sec. 902(b)(1) ($50/$60×$40)		33.33
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends from B Corporation	$50.00	
Other income	200.00	
Total pretax earnings and profits		250.00
Foreign income taxes (10%)		25.00
Earnings and profits		225.00
Foreign income taxes paid, and deemed to be paid, by A Corporation on or with respect to its earnings and profits ($25.00+$33.33)		58.33
Amounts required to be included in N Corporation's gross income for 1978 under sec. 951 with respect to A Corporation		180.00
Dividends paid to N Corporation:		
Dividends to which sec. 902(a) does not apply (from A Corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N Corporation's gross income with respect to A Corporation)	$180.00	
Dividends to which sec. 902(a) applies (from A Corporation's other earnings and profits)	20.00	
Total dividends paid to N Corporation		$200.00
N Corporation (domestic corporation):		
Foreign income taxes of corporations A and B deemed paid by N Corporation under sec. 960(a)(1) ($180/$225×$58.33)		46.66
Foreign income taxes of corporations A and B deemed paid by N Corporation under sec. 902(a) ($20/$225×$58.33)		5.18
Total foreign income taxes deemed paid by N Corporation under sec. 901		51.84

Example (*4*). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $22.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $175, consisting of $150 from its earnings and profits attributable to amounts required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $25 from its other earnings and profits. Corporation A does not distribute any dividends for 1978. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20%)		50.00
Earnings and profits		200.00
Amounts required to be included in N Corporation's gross income under sec. 951 for 1978 with respect to B Corporation		150.00
Dividends paid by B Corporation:		
Dividends to which sec. 902(b) does not apply (from B Corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N Corporation's gross income with respect to B Corporation)	$150.00	
Dividends to which sec. 902(b)(1) applies (from B Corporation's other earnings and profits)	25.00	
Total dividends paid to A Corporation		175.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		50.50
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under sec. 902(b)(1) ($25/$200×$50)		6.25
A Corporation (first-tier corporation):		
Pretax earnings and profits		175.00
Foreign income tax (10 percent)		17.50
Earnings and profits		157.50
Earnings and profits after exclusion of amounts attributable to dividends to which sec. 902(b) does not apply ($157.50 less [$150− ($150×0.10)])		22.50
Amount required to be included in N Corporation's gross income for 1978 under sec. 951 with respect to A Corporation		22.50
Dividends paid to N Corporation		0
N Corporation (domestic corporation):		
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1)(C) with respect to A Corporation:		
Tax actually paid by A Corporation ($22.50/$157.50×$17.50)	2.50	
Tax of B Corporation deemed paid by A Corporation under sec. 902(b)(1) ($22.50/$22.50×$6.25)	6.25	
		8.75
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1)(C) with respect to B Corporation ($150/$200×$50)		37.50
Total taxes deemed paid under sec. 960(a)(1)(C)		46.20

Example (*5*). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $22.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $175, consisting of $150 from its earnings and profits attributable to amounts required under section 951 to be included in N

Corporation's gross income with respect to B Corporation and $25 from its other earnings and profits. For 1978, A Corporation distributes $225, consisting of $135 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross, income with respect to B Corporation, $22.50 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to A Corporation, and $67.50 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a)(1) are determined as follows upon the basis of the facts assumed:

B Corporation (second-tier corporation):		
Pretax earnings and profits		$250.00
Foreign income taxes (20%)		50.00
Earnings and profits		200.00
Amounts required to be included in N Corporation's gross income for 1978 under sec. 951 with respect to B Corporation		150.00
Dividends paid by B Corporation:		
Dividends to which sec. 902(b) does not apply (from B Corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N Corporation's gross income with respect to B Corporation)	$150.00	
Dividends to which sec. 902(b) applies (from B Corporation's other earnings and profits)	$25.00	
Total dividends paid to A Corporation		$175.00
Foreign income taxes paid by B Corporation on or with respect to its accumulated profits		50.00
Foreign income taxes of B Corporation deemed paid by A Corporation for 1978 under sec. 902(b)(1) ($25/$200 × $50)		6.25
A Corporation (first-tier corporation):		
Pretax earnings and profits:		
Dividends received from B Corporation	175.00	
Other income	100.00	
Total pretax earnings and profits		275.00
Foreign income taxes (10 percent)		27.50
Earnings and profits		247.50
Earnings and profits after exclusion of amounts attributable to dividends to which sec. 902(b) does not apply ($247.50 less [$150 − ($150 × 0.10)])		112.50
Amount required to be included in N Corporation's gross income for 1978 under sec. 951 with respect to A Corporation		22.50
Distributions paid by A Corporation:		
Dividends to which sec. 902(a) does not apply (From A Corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N Corporation's gross income with respect to A Corporation)	22.50	
Dividends to which sec. 902(a) applies (from A Corporation's other earnings and profits)	202.50	
Total dividends paid to N Corporation	225.00	
N Corporation (domestic corporation):		
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1) with respect to—		
B Corporation ($150/$200 × $50)		37.50
A Corporation:		
Tax paid by A Corporation ($22.50/$247.50 × $27.50)	2.50	
Tax of B Corporation deemed paid by A Corporation under sec. 902(b)(1) ($22.50/$112.50 × $6.25)	1.25	3.75
Total taxes deemed paid under sec. 960(a)(1)		41.25
Foreign income taxes deemed paid by N Corporation under sec. 902(a)(1) with respect to A Corporation:		
Tax paid by A Corporation ($200.50/$247.50 × $27 50)	22.50	
Tax of B Corporation deemed paid by A Corporation ($67.50/ $112.50 × $6.25)	3.75	
Total taxes deemed paid under sec. 902(a)(1)		26.52
Total foreign income taxes deemed paid by N Corporation under sec. 901		67.05

Example (6). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $100 attributable to the earnings and profits of B Corporation for such year. For 1978, B Corporation distributes $150 consisting of $100 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $50 from its other earnings and profits. The country under the laws of which A Corporation is incorporated imposes an income tax of 10 percent on all income but exempts from tax dividends received from a subsidiary corporation. For 1978, A Corporation distributes $175, consisting of $100 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation, and $75 from its other earnings and profits. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

B Corporation (2d-tier corporation):		
Pretax earnings and profits		$200.00
Foreign income taxes (20%)		40.00
Earnings and profits		160.00
Amount required to be included in N Corporation's gross income for 1978 under sec. 951 with respect to B Corporation		100.00
Dividends paid by B Corporation:		
Dividends to which sec. 902(b) does not apply (from B corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N corporation's gross income with respect to B corporation)	$100.00	
Dividends to which sec. 902(b)(1) applies (from B corporation's other earnings and profits)	50.00	
Total dividends paid to A corporation		150.00
Foreign income taxes of B corporation deemed paid by A corporation for 1978 under sec. 902(b)(1) ($50/$100× $40)	12.50	
A corporation (1st-tier corporation):		
Pretax earnings and profits:		
Dividends received from B corporation	150.00	
Other income	100.00	
Total pretax earnings and profits		250.00
Foreign income taxes:		
On dividends received from B corporation	None	
On other income ($100×0.10)	10.00	
Total foreign income taxes		10.00
Earnings and profits:		
Attributable to dividends received from B corporation to which sec. 902(b) does not apply		100.00
Attributable to other income:		
Attributable to dividends received from B Corporation to which sec. 902(b)(1) applies	50.00	
Attributable to other income ($100−$10)	90.00	
Subtotal		140.00
Total earnings and profits		240.00
Earnings and profits after exclusion of amounts attributable to dividends to which sec. 902(b) does not apply ($240−$100)		140.00
Amount required to be included in N corporation's gross income for 1978 under sec. 951 with respect to A corporation		None
Dividends paid by A corporation:		
Dividends to which sec. 902(a) does not apply (from A corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N corporation's gross income with respect to A corporation)	None	
Dividends to which sec. 902(a)applies (from A corporation's other earnings and profits)	$175.00	
Total dividends paid to N corporation		$175.00
N corporation (domestic corporation):		
Foreign income taxes deemed paid by N corporation under sec. 960(a)(1) with respect to B corporation ($100/$160×$40)		25.00
Foreign income taxes deemed paid by N corporation under sec. 902(a) with respect to A corporation (allocation of earnings and profits being made under pars. (c)(2) and (d) of this section):		
Tax paid by A corporation in respect to dividends received from B Corporation to which sec. 902(b) does not apply ($100/ $100×$0)	None	
Tax paid by A corporation in respect to its other income ($75/ $140×$10)	5.36	
Tax paid by B corporation deemed paid by A corporation in respect to such other income ($75/$140×$12.50)	6.70	
Total taxes deemed paid under sec. 902(a)		12.06
Total foreign income taxes deemed paid by N corporation under sec. 901	37.06	

Example (7). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, N Corporation is required under section 951 to include in gross income $150 attributable to the earnings and profits of B Corporation for such year and $47.50 attributable to the earnings and profits of A Corporation for such year. For 1978, B Corporation distributes $200, consisting of $150 from its earnings and profits attributable to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation and $50 from its other earnings and profits. The country under the laws of which A Corporation is incorporated imposes an income tax of 5 percent on dividends received from a subsidiary corporation and 20 percent on other income. For 1978, A Corporation distributes $100 from its earnings and profits to N Corporation, such amount being attributable under paragraph (e) of § 1.959-3 to the amount required under section 951 to be included in N Corporation's gross income with respect to B Corporation. The foreign income taxes deemed paid by N Corporation for 1978 under section 960(a)(1) and section 902(a) are determined as follows on the basis of the facts assumed:

B Corporation (2d-tier corporation):	
Pretax earnings and profits	$250.00
Foreign income taxes (20 percent)	150.00
Earnings and profits	200.00

Amount required to be included in N Corporation's gross income for 1978 under sec. 951 with respect to B corporation		150.00
Dividends paid by B corporation:		
Dividends to which sec. 902(b) does not apply (from B corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N corporation's gross income with respect to B corporation)	$150.00	
Dividends to which sec. 902(b)(1) applies (from B corporation's other earnings and profits)	50.00	
Total dividends paid to A corporation		200.00
Foreign income taxes of B corporation deemed paid by A corporation for 1978 under sec. 902(b)(1) ($50/$200×$50)		12.50
A corporation (1st-tier corporation):		
Pretax earnings and profits:		
Dividends received from B corporation	200.00	
Other income	100.00	
Total pretax earnings and profits		300.00
Foreign income taxes:		
On dividends received from B corporation to which sec. 902(b) does not apply ($150× 0.05)		7.50
On other income:		
Dividends received from B corporation to which sec. 902(b)(1) applies ($50× 0.05)	2.50	
Other income of A corporation ($100×0.20)	20.00	
Total		22.50
Total foreign income taxes		30.00
Earnings and profits:		
Attributable to dividends received from B corporation to which sec. 902(b) does not apply ($150−$7.50)		142.50
Attributable to other income:		
Attributable to dividends received from B corporation to which sec. 902(b)(1) applies ($50−$2.50)	47.50	
Attributable to other income ($100−$20	80.00	
Total		127.50
Total earnings and profits		270.00
Earnings and profits after exclusion of amounts attributable to dividends to which sec. 902(b) does not apply ($270 less $142.50)		127.50
Amount required to be included in N corporation's gross income for 1978 under sec. 951 with respect to A corporation		47.50
Dividends paid by A Corporation:		
Dividends to which sec. 902(a) does not apply (from A corporation's earnings and profits in respect of which an amount is required under sec. 951 to be included in N corporation's gross income with respect to A corporation)	None	
Dividends to which sec. 902(a)(1) applies (from A corporation's other earnings and profits)	$100.00	
Total dividends paid to N corporation		$100.00
N Corporation (domestic corporation):		
Foreign income taxes deemed paid by N corporation under sec. 960(a)(1) with respect to—B corporation ($150/$200×$50)		37.50
A corporation (allocation of earnings and profits being made under § 1.960-1(c)(3) and par. (d) of this sec.):		
Tax paid by A corporation ($47.50/$127.50×$22.50)	8.38	
Tax of B corporation deemed paid by A corporation under sec. 902(b)(1) ($47.50/$127.50×$12.50)	4.66	
Total		13.04
Total taxes deemed paid under sec. 960(a)(1)		50.54
Foreign income taxes deemed paid by N corporation under sec. 902(a) with respect to A corporation (allocations of earnings and profits being made under pars. (c)(2) and (d) of this sec.) ($100/$142.50×$7.50)	5.26	
Total foreign income taxes deemed paid by N Corporation under sec. 901		55.80

[T.D. 7120, 36 FR 10854, June 4, 1971; 36 FR 11924, June 23, 1971, as amended by T.D. 7334, 39 FR 44212, Dec. 23, 1974; 40 FR 1014, Jan. 6, 1975; 40 FR 2802, Jan. 16, 1975; T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960-3 Gross-up of amounts included in income under section 951.

(a) *General rule for including taxes in income.* Any taxes deemed paid by a domestic corporation for the taxable year pursuant to section 960(a)(1) shall, except as provided in paragraph (b) of this section, be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and § 1.78-1.

(b) *Certain taxes not included in income.* Any taxes deemed paid by a domestic corporation for the taxable year pursuant to section 902(a) or section 960(a)(1) shall not be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and § 1.78-1 to the extent that such taxes are paid or accrued by the first-tier corporation or its second-tier corporation, as the case may be, on or with respect to an amount which is excluded from the gross income of such foreign corporation under section 959(b) and § 1.959-2 as distributions from the earnings and profits of another controlled foreign corporation attributable to an amount which is, or has been, required to be included in the gross income of the domestic corporation under section 951.

(c) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B. All such corporations use the calendar year as the taxable year. For 1978, B Corporation, after having paid $20 of foreign income taxes, has $80 in earnings and profits, which are attributable to the amount required to be included in N Corporation's gross income for such year under section 951 with respect to B Corporation and all of which are distributed to A Corporation in such year. The dividend so received from B Corporation is excluded from A Corporation's gross income under section 959(b) and § 1.959-2. An income tax of 10 percent is required to be withheld from such dividend by the foreign country under the laws of which B Corporation is created, and the foreign country under the laws of which A Corporation is created imposes an income tax of $22 on the dividend received from B Corporation. For 1978, A Corporation's earnings and profits are $50 ($80 – [0.10 × $80] – $22), which it distributes in such year to N Corporation. For 1978, N Corporation is required under section 951 to include $80 in gross income with respect to B Corporation and also is required under the gross-up provisions of section 78 to include in gross income $20 ($80/$80 × $20), the amount equal to the foreign income taxes of B Corporation which are deemed paid by N Corporation under section 960(a)(1). Under paragraph (b) of this section N Corporation is not required to include in gross income the $30 ($8 + $22) of foreign income taxes which are paid by A Corporation in connection with the dividend received from B Corporation and which are deemed paid by N Corporation under section 902(a) and paragraph (c) of § 1.960-2.

Example (2). Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which owns all the one class of stock of controlled foreign corporation B, which in turn owns all the one class of stock of controlled foreign corporation C. All such corporations use the calendar year as the taxable year. For 1978, C Corporation, after having paid $20 of foreign income taxes, has $80 in earnings and profits, which are attributable to the amount required to be included in N Corporation's gross income for such year under section 951 with respect to C Corporation and all of which are distributed to B Corporation in such year. After having paid foreign income taxes of $10 on the dividend received from C Corporation, B Corporation distributes the balance of $70 to A Corporation. After having paid foreign income taxes of $5 on the dividend received from B Corporation, A Corporation distributes the balance of $65 to N Corporation. The dividend so received by B Corporation, and in turn by A Corporation, is excluded from the gross income of such corporations under section 959(b) and § 1.959-2. Under paragraph (b) of this section N Corporation is not required to include in gross income the $15 ($10 + $5) of foreign income taxes which are paid by corporations B and A, respectively, in connection with the dividend so received and which are deemed paid by N Corporation under section 902(a) and paragraphs (b) and (c) of § 1.960-2.

[T.D. 7120, 36 FR 10856, June 4, 1971, as amended by T.D. 7481, 42 FR 20130, Apr. 18, 1977; T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960-4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.

(a) *Increase in section 904(a) limitation for the taxable year of exclusion*—(1) *In general.* The applicable limitation under section 904(a) for a taxpayer's taxable year (hereinafter in this section referred to as the "taxable year of exclusion") in which he receives an amount which is excluded from gross income under section 959(a)(1) and which is attributable to a controlled foreign corporation's earnings and profits in respect of which an amount was required to be included in the gross income of such taxpayer under section 951(a) for a taxable year (hereinafter in this section referred to as the "taxable year of inclusion") previous to the taxable year of exclusion shall be increased under section 960(b)(1) by the amount described in paragraph (b) of this section if the conditions described in subparagraph (2) of this paragraph are satisfied.

(2) *Conditions under which increase in limitation is allowed for the taxable year of exclusion.* The increase in limitation described in subparagraph (1) of this paragraph for the taxable year of exclusion shall be made only if the taxpayer—

(i) For the taxable year of inclusion either chose to claim a foreign tax credit as provided in section 901 or did not pay or accrue any foreign income taxes,

(ii) Chooses to claim a foreign tax credit as provided in section 901 for the taxable year of exclusion, and

(iii) For the taxable year of exclusion pays, accrues, or is deemed to have paid foreign income taxes with respect to the amount, described in subparagraph (1) of this paragraph, which is excluded from his gross income for such year under section 959(a)(1).

(b) *Amount of increase in limitation for the taxable year of exclusion.* The amount of increase under section 960(b)(1) in the applicable limitation under section 904(a) for the taxable year of exclusion shall be—

(1) The amount by which the applicable section 904(a) limitation for the taxable year of inclusion was increased, determined as provided in paragraph (c) of this section, by reason of the inclusion of the amount in the taxpayer's income for such year under section 951(a), reduced by

(2) The amount of foreign income taxes allowed as a credit under section 901 for such taxable year of inclusion and which were allowable to such taxpayer solely by reason of the inclusion of such amount in his gross income under section 951(a), as determined under paragraph (d) of this section, and then by

(3) The additional reduction for such taxable year of inclusion arising by reason of increases in limitation under section 960(b)(1) for taxable years intervening between such taxable year of inclusion and such taxable year of exclusion, as determined under paragraph (e) of this section in respect of such inclusion under section 951(a),

except that the amount of increase determined under this paragraph for the taxable year of exclusion shall in no case exceed the amount of foreign income taxes paid, accrued, or deemed to be paid by such taxpayer for such taxable year of exclusion with respect to the amount, described in paragraph (a)(1) of this section, which is excluded from gross income for such year under section 959(a)(1).

(c) *Determination of increase in limitation for the taxable year of inclusion.* The amount of the increase in the applicable limitation under section 904(a) for the taxable year of inclusion which arises by reason of the inclusion of the amount in gross income under section 951(a) shall be the amount of the applicable limitation under section 904(a) for such year reduced by the amount which would have been the applicable limitation under section 904(a) for such year if the amount had not been included in gross income for such year under section 951(a).

(d) *Determination of foreign income taxes allowed for taxable year of inclusion by reason of section 951(a) amount.* The amount of foreign income taxes allowed as a credit under section 901 for the taxable year of inclusion which were allowable solely by reason of the inclusion of the amount in gross income for such year under section 951(a) shall be the amount of foreign income taxes allowed as a credit under section 901 for such year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for such year if the amount had not been included in gross income for such year under section 951(a). For purposes of this paragraph, the term "foreign income taxes" includes foreign income taxes paid or accrued, and foreign income taxes deemed paid under section 902, section 904(d), and section 960(a), for the taxable year of inclusion.

(e) *Additional reduction for the taxable year of inclusion arising by reason of increases in limitation for intervening years.* The amount of increase in the applicable limitation under section 904(a) for the taxable year of inclusion shall also be reduced, after first deducting the foreign income taxes described in paragraph (b)(2) of this section, by any increases in limitation which arise under section 960(b)(1)—by reason of any earlier exclusions under section 959(a)(1) in respect of the same inclusion under section 951(a) for such taxable year of inclusion—for the first, second, third, fourth, etc., succeeding taxable years of exclusion, in that order, which follow such taxable year of inclusion and precede the taxable year of exclusion in respect of which the increase in limitation under section 960(b)(1) and paragraph (b) of this section is being determined. The amount of any increase in limitation which arises under section 960(b)(1) for any such succeeding taxable year of exclusion shall be the amount of foreign income taxes allowed as a credit under section 901 for each such taxable year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for each such year if the limitation for each such year were not increased under section 960(b)(1). For any such succeeding taxable year of exclusion for which the taxpayer does not choose to claim a foreign tax credit as provided in section 901, the same increase in limitation under section 960(b)(1) shall be treated as having been made, for purposes of this paragraph, which would have been made for such taxable year if the taxpayer had chosen to claim the foreign tax credit for such year.

(f) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). Domestic corporation N owns all of the one class of stock of controlled foreign corporation A. Corporation A, after paying foreign income taxes of $30, has earnings and profits for 1978 of $70, all of which are attributable to an amount required under section 951(a) to be included in N Corporation's gross income for 1978. Both corporations use the calendar year as the taxable year. For 1979 and 1980, A Corporation has no earnings and profits attributable to an amount required to be included in N Corporation's gross income under section 951(a); for each such year it makes a distribution of $35 (from its earnings and profits for 1978) from which a foreign income tax of $6 is withheld. For each of 1978, 1979, and 1980, N Corporation derives taxable income of $50 from sources within the United States and claims a foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2).

The United States tax payable by N Corporation is determined as follows, assuming a corporate tax rate of 48 percent:

1978

Taxable income of N Corporation:		
U.S. sources		$50.00
Sources without the U.S.:		
Amount required to be included in N Corporation's gross income under sec. 951(a)	$70.00	
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1) and included in N Corporation's gross income under sec. 78 ($30 × $70/$70)	30.00	100.00
Total taxable income		150.00
U.S. tax payable for 1978:		
U.S. tax before credit ($150 × 0.48)		72.00
Credit: Foreign income taxes of $30, but not to exceed overall limitation of $48 for 1978 ($100/$150 × $72)		30.00
U.S. tax payable		42.00

1979

Taxable income of N Corporation, consisting of income from U.S. sources		$50.00
U.S. tax before credit ($50 × 0.48)		24.00
Section 904(a)(2) overall limitation for 1979:		
Limitation for 1979 before increase under sec. 960(b)(1) ($24 × $0/$50)		0
Plus: Increase in overall limitation for 1979 under sec. 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under sec. 951(a) for 1978 ($48 – [($50 × 0.48) × $0/$50])	$48.00	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such sec. 951(a) inclusion ($30 – $0)	30.00	
Balance	18.00	
But: Such balance not to exceed foreign income taxes paid by N Corporation for 1979 with respect to $35 distribution excluded under sec. 959(a)(1) ($6 tax withheld)	6.00	6.00
Overall limitation for 1979		6.00
U.S. tax payable for 1979:		
U.S. tax before credit ($50 × 0.48)		24.00
Credit: Foreign income taxes of $6, but not to exceed overall limitation of $6 for 1966		6.00
U.S. tax payable		18.00

1980

Taxable income of N Corporation, consisting of income from U.S. sources	$50.00
U.S. tax before credit ($50 × 0.48)	24.00
Section 904(a)(2) overall limitation for 1980:	
Limitation for 1980 before increase under sec. 960(b)(1) ($24 × $0/$50)	0

1980

Plus: Increase in overall limitation for 1980 under sec. 960(b) (1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under sec. 951(a) for 1978 ($48 – [($50 × 0.48) × $0/$50])	$48.00	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such sec. 951(a) inclusion ($30 – $0)	30.00	
Tentative balance	18.00	
Less: Increase in overall limitation under sec. 960(b)(1) for 1979 by reason of such sec. 951(a) inclusion	$6.00	
Balance	12.00	
But: Such balance not to exceed foreign income taxes paid by N Corporation for 1980 with respect to $35 distribution excluded under sec. 959(a)(1) ($6 tax withheld)	6.00	$6.00
Overall limitation for 1980		6.00
U.S. tax payable for 1980:		
U.S. tax before credit ($50 × 0.48)		24.00
Credit: Foreign income taxes of $6, but not to exceed overall limitation of $6 for 1967		6.00
U.S. tax payable		18.00

Example (*2*). The facts for 1978, 1979, and 1980, are the same as in example (1), except that in 1977, to which the section 904(a)(2) overall limitation applies, N Corporation pays $18 of foreign income taxes in excess of the overall limitation and that such excess is not absorbed as a carryback to 1975 or 1976 under section 904(c). Therefore, there is no increase under section 960(b)(1) in the overall limitation for 1979 or 1980 since the amount ($48) by which the 1978 overall limitation was increased by reason of the inclusion in N Corporation's gross income for 1978 under section 951(a), less the foreign income taxes ($48) allowed as a credit which were allowable solely by reason of such inclusion, is zero. The foreign income taxes so allowed as a credit for 1978 which were allowable solely by reason of such section 951(a) inclusion consist of the $30 of foreign income taxes deemed paid for 1978 under section 960(a)(1) and the $18 of foreign income taxes for 1977 carried over and deemed paid for 1978 under section 904(c).

Example (*3*). (a) Domestic corporation N owns all the one class of stock of controlled foreign corporation A, which in turn owns all the one class of stock of controlled foreign corporation B. All corporations use the calendar years as the taxable year. Corporation B, after paying foreign income taxes of $30, has earnings and profits for 1978 of $70, all of which is attributable to an amount required under section 951(a) to be included in N Corporation's gross income for 1978, and $35 of which it distributes in such year to A Corporation. For 1978, A Corporation, after paying foreign income taxes of $5 on such dividend from B Corporation, has total earnings and profits of $30, all of which it distributes in such year to N Corporation, a foreign income tax of $3 being withheld therefrom.

(b) For 1979, B Corporation has no earnings and profits, but distributes in such year to A Corporation the $35 remaining of its earnings and profits for 1965. For 1979, A Corporation, after paying foreign income taxes of $5 on such dividend from B Corporation, has total earnings and profits of $30, all of which it distributes to N Corporation, a foreign income tax of $3 being withheld therefrom.

(c) For each of 1978 and 1979, N Corporation has taxable income of $100 from United States sources and claims a foreign tax credit under section 901, determined by applying the overall limitation under section 904(a) (2). The United States tax payable by N Corporation is determined as follows, assuming a corporate tax rate of 48 percent:

1978

Taxable income of N Corporation:		
U.S. sources		$100
Sources without the U.S.:		
Amount required to be included in N Corporation's gross income under sec. 951(a) with respect to B Corporation	$70	
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1) and included in N Corporation's gross income under sec. 78 ($30 × $70/$70)	30	100
Total taxable income		200
U.S. tax payable for 1978:		
U.S. tax before credit ($200 × 0.48)		96
Credit: Foreign income taxes of $38 ([$30 × $70/$70] + $3), but not to exceed overall limitation of $48 ($96 × $100/$200)		38
U.S. tax payable		58

1979

Taxable income of N Corporation, consisting of income from U.S. sources	$100
U.S. tax before credit ($100 × 0.48)	48
Section 904(a)(2) overall limitation for 1979:	
Limitation for 1979 before increase under sec. 960(b)(1) ($48 × $0/$100)	0

1979

Plus: Increase in overall limitation for 1979 under sec. 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under sec. 951(a) for 1978 ($48 – [($100 × 0.48) × $0/$100])	$48	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such sec. 951(a) inclusion ($38 – $0)	38	
Balance	10	
But: Such balance not to exceed foreign income taxes paid and deemed paid by N Corporation for 1979 with respect to $30 distribution excluded under sec. 959(a)(1) ([$5 × $30/$30] + $3)	8	8
Overall limitation for 1979		8
U.S. tax payable for 1979:		
U.S. tax before credit ($100 × 0.48)		48
Credit: Foreign income taxes of $8 ($3 + $5), but not to exceed overall limitation of $8 for 1979		8
U.S. tax payable		40

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960–5 Credit for taxable year of inclusion binding for taxable year of exclusion.

(a) *Taxes not allowed as a deduction for taxable year of exclusion.* In the case of any taxpayer who—

(1) Chooses to claim a foreign tax credit as provided in section 901 for the taxable year for which he is required to include in gross income under section 951(a) an amount attributable to the earnings and profits of a controlled foreign corporation, and

(2) Does not choose to claim a foreign tax credit as provided in section 901 for a taxable year in which he receives an amount which is excluded from gross income under section 959(a)(1) and which is attributable to such earnings and profits of such controlled foreign corporation,

No deduction shall be allowed under section 164 for the taxable year of such exclusion for any foreign income taxes paid or accrued on or with respect to such excluded amount.

(b) *Illustration.* The application of this section may be illustrated by the following example:

Example. Domestic Corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. All of A Corporation's earnings and profits of $80 for 1978 (after payment of foreign income taxes of $20 on its total income of $100 for such year) are attributable to amount required under section 951(a) to be included in N Corporation's gross income for 1978. For 1978, N Corporation chooses to claim a foreign tax credit for the $20 of foreign income taxes which for such year are paid by A Corporation and deemed paid by N Corporation under section 960(a)(1) and paragraph (c)(1) of § 1.960-1. For 1979, A Corporation distributes the entire $80 of 1978 earnings and profits, a foreign income tax of $8 being withheld therefrom. Although N Corporation does not choose to claim a foreign tax credit for 1979, it may not deduct such $8 of foreign income taxes under section 164. Corporation N may, however, deduct under such section a foreign income tax of $4 which is withheld from a distribution of $40 by A Corporation during 1979 from its 1979 earnings and profits.

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960–6 Overpayments resulting from increase in limitation for taxable year of exclusion.

(a) *Amount of overpayment.* If an increase in the limitation under section 960(b)(1) and § 1.960-4 for a taxable year of exclusion exceeds the tax (determined before allowance of any credits against tax) imposed by chapter 1 of the Code for such year, the amount of such excess shall be deemed an overpayment of tax for such year and shall be refunded or credited to the taxpayer in accordance with chapter 65 (section 6401 and following) of the Code.

(b) *Illustration.* The application of this section may be illustrated by the following example:

Example. Domestic corporation N owns all the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year. For 1978, A Corporation has total income of $100,000 on which it pays foreign income taxes of $20,000. All of A Corporation's earnings and profits for 1978 of $80,000 are attributable to an amount which is required under section 951(a) to be included in N Corporation's gross income for 1978. By reason of such income inclusion N Corporation is deemed for 1978 to have paid under section 960(a)(1), and is required under section 78 to include in gross income for such year, the $20,000 ($20,000×$80,000/$80,000) of foreign income taxes paid by A Corporation for such year. Corporation N also derives $100,000 taxable income from sources within the United States for 1978. For 1979, N Corporation has $25,000 of taxable income, all of which is derived from sources within the United States. No part of A Corporation's earnings and profits for 1979 is attributable to an amount required under section 951(a) to be included in N Corporation's gross income. During 1979, A Corporation makes one distribution consisting of its $80,000 earnings and profits for 1978, all of which is excluded under section 959(a)(1) from N Corporation's gross income for 1979, and from which distribution foreign income taxes of $10,000 are withheld. For 1978 and 1979, N Corporation claims the foreign tax credit under section 901, determined by applying the overall limitation under section 904(a)(2). The United States tax of N Corporation is determined as follows for such years, assuming a corporate tax rate of 22 percent, a surtax of 26 percent and a surtax exemption of $25,000:

1978

Taxable income of N Corporation:		
U.S. sources		$100,000
Sources without the U.S.:		
Amount required to be included in N Corporation's gross income under sec. 951(a)	$80,000	
Foreign income taxes deemed paid by N Corporation under sec. 960(a)(1) and included in N Corporation's gross income under sec. 78 ($20,000 × $80,000/$80,000)	20,000	100,000
Total taxable income		200,000
U.S. tax payable for 1978:		
U.S. tax before credit ([$200,000 × 0.22] + [$175,000 × 0.26])		89,500
Credit: Foreign income taxes of $20,000, but not to exceed overall limitation of $44,750 ($89,500 × $100,000/$200,000)		20,000
U.S. tax payable		69,500

1979

Taxable income of N Corporation, consisting of income from U.S. sources	$25,000
U.S. tax before credit ($25,000 × 0.22)	5,500

1979

Section 904(a)(2) overall limitation for 1979:		
Limitation for 1979 before increase under sec. 960(b)(1) ($5,500 × $0/$25,000)		0
Plus: Increase in overall limitation for 1979 under sec. 960(b)(1):		
Amount by which 1978 overall limitation was increased by reason of inclusion in N Corporation's gross income under sec. 951(a) for 1978 ($44,750 – [$41,500 × $0/ $100,000])	$44,750	
Less: Foreign income taxes allowed as a credit for 1978 which were allowable solely by reason of such sec. 951(a) inclusion ($20,000 – $0)	20,000	
Balance	24,750	
But: Such balance not to exceed foreign income taxes paid by N Corporation for 1979 with respect to $80,000 distribution excluded under sec. 959(a)(1) ($10,000 tax withheld)	10,000	10,000
Overall limitation for 1979		10,000
U.S. tax payable for 1979:		
U.S. tax before credit ($25,000 × 0.22)		5,500
Credit: Foreign income taxes of $10,000, but not to exceed overall limitation of $10,000 for 1979		10,000
U.S. tax payable		None
Overpayment of tax for 1979:		
Increase in limitation under sec. 960(b)(1) for 1979		10,000
Less: Tax imposed for 1979 under chapter 1 of the Code		5,500
Excess treated as overpayment		4,500

[T.D. 7120, 36 FR 10859, June 4, 1971, as amended by T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.960-7 Effective dates.

(a) *General rule.* Except as provided in paragraph (b), the rules contained in §§ 1.960-1—1.960-6 shall apply to taxable years of foreign corporations beginning after December 31, 1962, and taxable years of U.S. corporate shareholders within which or with which the taxable year of such foreign corporation ends.

(b) *Exception for less developed country corporations.* If for any taxable year beginning after December 31, 1962, and before January 1, 1976, a first-tier foreign corporation qualified as a less developed country corporation as defined in 26 CFR 1.902-2 revised as of April 1, 1978, the rules pertaining to less developed country corporations contained in 26 CFR 1.960-1—1.960-6 revised as of April 1, 1978, shall apply to any amounts required to be included in gross income under section 951 for such taxable year.

[T.D. 7649, 44 FR 60089, Oct. 18, 1979]

§ 1.961-1 Increase in basis of stock in controlled foreign corporations and of other property.

(a) *Increase in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the basis of a United States shareholder's—

(i) Stock in a controlled foreign corporation; or

(ii) Property (as defined in paragraph (b)(1) of this section) by reason of the ownership of which he is considered under section 958(a)(2) as owning stock in a controlled foreign corporation

shall be increased under section 961(a), as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation, by the amount required to be included with respect to such stock or such property in such shareholder's gross income under section 951(a) for his taxable year in which or with which such taxable year of such corporation ends. The increase in basis provided by the preceding sentence shall be made only to the extent to which such amount required to be included in gross income under section 951(a) was so included in gross income.

(2) *Limitation on amount of increase in case of election under section 962.* In the case of a United States shareholder who makes the election under section 962 for the taxable year, the amount of the increase in basis provided by subparagraph (1) of this paragraph shall not exceed the amount of United States tax paid in accordance with such election with respect to the amounts included in such shareholder's gross income under section 951(a) for such year (as determined under § 1.962-1).

(b) *Rules of application*—(1) *Property defined.* The property of a United States shareholder referred to in paragraph (a)(1)(ii) of this section shall consist of—

(i) Stock in a foreign corporation;

(ii) An interest in a foreign partnership; or

(iii) A beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)).

(2) *Increase with respect to each share of stock.* Any increase under paragraph (a) of this section in the basis of a United States shareholder's stock in a foreign corporation shall be made in the amount included in gross income under section 951(a) or in the amount of United States tax paid in accordance with an election under section 962, as the case may be, with respect to each share of such stock.

(c) *Illustration.* The application of this section may be illustrated by the following examples:

Example (1). Domestic corporation M owns 800 of the 1,000 shares of the one class of stock in controlled foreign corporation R which owns all of the one class of stock in controlled foreign corporation S. Corporations M, R, and S use the calendar year as a taxable year. In 1964, S Corporation has $100,000 of earnings and profits after the payment of $11,250 of foreign income taxes, and $100,000 of subpart F income. Corporation R has no earnings and profits. With respect to S Corporation, M Corporation is required to include in gross income $80,000 (800/1,000 × $100,000) under section 951(a), and $9,000 ($80,000/$100,000 × $11,250) under section 78. On December 31, 1964, M Corporation must increase the basis of each share of its stock in R Corporation by $100 ($80,000/800).

Example (2). A, an individual United States shareholder, owns all of the 1,000 shares of the one class of stock in controlled foreign corporation T. Corporation T and A use the calendar year as a taxable year. In 1964, T Corporation has $80,000 of earnings and profits after the payment of $20,000 of foreign income taxes, and $80,000 of subpart F income. A makes the election under section 962 for 1964 and in accordance with such election pays a United States tax of $23,000 with respect to the $80,000 included in his gross income under section 951(a). On December 31, 1964, A must increase the basis of each share of his stock in T Corporation by $23 ($23,000/1,000).

[T.D. 6850, 30 FR 11854, Sept. 16, 1978]

§ 1.961-2 Reduction in basis of stock in foreign corporations and of other property.

(a) *Reduction in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the adjusted basis of a United States person's—

(i) Stock in a foreign corporation;

(ii) Interest in a foreign partnership; or

(iii) Beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)),

with respect to which such United States person receives an amount which is excluded from gross income under section 959(a), shall be reduced under section 961(b), as of the time such person receives such excluded amount, by the sum of the amount so excluded and any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(2) *Limitation on amount of reduction in case of election under section 962.* In the case of a distribution of earnings and profits attributable to amounts with respect to which an election under section 962 has been made, the amount of the reduction in basis provided by subparagraph (1) of this paragraph shall not exceed the sum of—

(i) The amount of such distribution which is excluded from gross income under section 959(a) after the application of section 962(d) and § 1.962-3; and

(ii) Any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(b) *Reduction with respect to each share of stock.* Any reduction under paragraph (a) of this section in the adjusted basis of a United States person's stock in a foreign corporation shall be made with respect to each share of such stock in the sum of—

(1)(i) The amount excluded from gross income under section 959(a); or

(ii) The amount excluded from gross income under section 959(a) after the application of section 962(d) and § 1.962-3; and

(2) The amount of any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(c) *Amount in excess of basis.* To the extent that the amount of the reduction in the adjusted basis of property provided by paragraph (a) of this section exceeds such adjusted basis, the amount shall be treated as gain from the sale or exchange of property.

(d) *Illustration.* The application of this section may be illustrated by the following examples:

Example (1). (a) Domestic corporation M owns all of the 1,000 shares of the one class of stock in controlled foreign corporation R, which owns all of the 500 shares of the one class of stock in controlled foreign corporation S. Each share of M Corporation's stock in R Corporation has a basis of $200. Corporations M, R, and S use the calendar year as a taxable year. In 1963, S Corporation has $100,000 of earnings and profits after the payment of $50,000 of foreign income taxes and $100,000 of subpart F income. For 1963, M Corporation includes $100,000 in gross income under section 951(a) with respect to S Corporation. In accordance with the provisions of § 1.961-1, M Corporation increases the basis of each of its 1,000 shares of stock in R Corporation to $300 ($200 + $100,000/1,000) as of December 31, 1963.

(b) On July 31, 1964, M Corporation sells 250 of its shares of stock in R Corporation to domestic corporation N at a price of $350 per share. Corporation N satisfies the requirements of paragraph (d) of § 1.959-1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, the earnings and profits attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963 are distributed to R Corporation which incurs a withholding tax of $10,000 on such distribution (10 percent of $100,000) and an additional foreign income tax of 33⅓ percent or $30,000 by reason of the inclusion of the net distribution of $90,000 ($100,000 minus $10,000) in its taxable income for 1964. On June 30, 1965, R Corporation distributes the remaining $60,000 of such earnings and profits to corporations M and N: Corporation M receives $45,000 (750/1,000 × $60,000) and excludes such amount from gross income under section 959(a); Corporation N receives $15,000 (250/1,000 × $60,000) and, as M Corporation's successor in interest, excludes such amount from gross income under section 959(a). As of June 30, 1965, M Corporation must reduce the adjusted basis of each of its 750 shares of stock in R Corporation to $200 ($300 minus ($45,000/750 + $10,000/1,000 + $30,000/1,000)); and N Corporation must reduce the basis of each of its 250 shares of stock in R Corporation to $250 ($350 minus ($15,000/250 + $10,000/1,000 + $30,000/1,000)).

Example (2). The facts are the same as in paragraph (a) of example (1), except that in addition, on July 31, 1964, R Corporation sells its 500 shares of stock in S Corporation to domestic corporation P at a price of $600 per share. Corporation P satisfies the requirements of paragraph (d) of § 1.959-1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, S Corporation distributes $100,000 of earnings and profits to P Corporation, which earnings and profits are attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963. Corporation P incurs a withholding tax of $10,000 on the distribution from S Corporation (10 percent of $100,000). As M Corporation's successor in interest, P Corporation excludes the $90,000 it receives from gross income under section 959(a). As of September 30, 1964, P Corporation must reduce the basis of each of its 500 shares of stock in S Corporation to $400 ($600 minus ($90,000/500 + $10,000/500)).

[T.D. 6850, 30 FR 11854, Sept. 16, 1965]

§ 1.962-1 Limitation of tax for individuals on amounts included in gross income under section 951(a).

(a) *In general.* An individual United States shareholder may, in accordance with § 1.962-2, elect to have the provisions of section 962 apply for his taxable year. In such case—

(1) The tax imposed under chapter 1 of the Internal Revenue Code on all amounts which are included in his gross income for such taxable year under section 951(a) shall (in lieu of the tax determined under section 1) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation (determined in accordance with paragraph (b)(1) of this section), and

(2) For purposes of applying section 960(a)(1) (relating to foreign tax credit) such amounts shall be treated as if received by a domestic corporation (as provided in paragraph (b)(2) of this section).

Thus, an individual United States shareholder may elect to be subject to tax at corporate rates on amounts included in his gross income under section 951(a) and to have the benefit of a credit for certain foreign taxes paid with respect to the earnings and profits attributable to such amounts. Section 962 also provides rules for the treatment of an actual distribution of earnings and profits previously taxed in accordance with an election of the benefits of this section. See § 1.962-3. For transitional rules for certain taxable years, see § 1.962-4.

(b) *Rules of application.* For purposes of this section—

(1) *Application of section 11.* For purposes of applying section 11 for a taxable year as provided in paragraph (a)(1) of this section in the case of an electing United States shareholder—

(i) *Determination of taxable income.* The term "taxable income" as used in section 11 shall mean the sum of—

(*a*) All amounts required to be included in his gross income under section 951(a) for such taxable year; plus

(*b*) All amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in (*a*) of this subdivision if such shareholder were a domestic corporation.

For purposes of this section, such sum shall not be reduced by any deduction of the United States shareholder even if such shareholder's deductions exceed his gross income.

(ii) *Limitation on surtax exemption.* The surtax exemption provided by section 11(c) shall not exceed an amount which bears the same ratio to $25,000 ($50,000 in the case of a taxable year ending after December 31, 1974, and before January 1, 1976) as the amounts included in his gross income under section 951(a) for the taxable year bear to his pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which such United States shareholder includes any amount in his gross income under section 951(a) for the taxable year.

(2) *Allowance of foreign tax credit*—(i) *In general.* Subject to the applicable limitation of section 904 and to the provisions of this subparagraph, there shall be allowed as a credit against the United States tax on the amounts described in subparagraph (1)(i) of this paragraph the foreign income, war profits, and excess profits taxes deemed paid under section 960(a)(1) by the electing United States shareholder with respect to such amounts.

(ii) *Application of section 960(a)(1).* In applying section 960(a)(1) for purposes of this subparagraph in the case of an electing United States shareholder, the term "domestic corporation" as used in sections 960(a) (1) and 78, and the term "corporation" as used in section 901, shall be treated as referring to such shareholder with respect to the amounts described in subparagraph (1)(i) of this paragraph.

(iii) *Carryback and carryover of excess tax deemed paid.* For purposes of this subparagraph, any amount by which the foreign income, war profits, and excess profits taxes deemed paid by the electing United States shareholder for any taxable year under section 960(a)(1) exceed the limitation determined under subdivision (iv)(*a*) of this subparagraph shall be treated as a carryback and carryover of excess tax paid under section 904(d), except that in no case shall excess tax paid be deemed paid in a taxable year if an election under section 962 by such shareholder does not apply for such taxable year. Such carrybacks and carryovers shall be applied only against the United States tax on amounts described in subparagraph (1)(i) of this paragraph.

(iv) *Limitation on credit.* For purposes of determining the limitation under section 904 on the amount of the credit for foreign income, war profits, and excess profits taxes—

(*a*) Deemed paid with respect to amounts described in subparagraph (1)(i) of this paragraph, the electing United States shareholder's taxable income shall be considered to consist only of the amounts described in such subparagraph (1)(i), and

(*b*) Paid with respect to amounts other than amounts described in subparagraph (1)(i) of this paragraph, the electing United States share- holder's taxable income shall be considered to consist only of amounts other than the amounts described in such subparagraph (1)(i).

(v) *Effect of choosing benefits of sections 901 to 905.* The provisions of this subparagraph shall apply for a taxable year whether or not the electing United States shareholder chooses the benefits of subpart A of part III of subchapter N of Chapter 1 (sections 901 to 905) of the Internal Revenue Code for such year.

(c) *Illustration.* The application of this section may be illustrated by the following example:

Example. Throughout his taxable year ending December 31, 1964, A, an unmarried individual who is not the head of a household, owns 60 of the 100 shares of the one class of stock in foreign corporation M and 80 of the 100 shares of the one class of stock in foreign corporation N. A and corporations M and N use the calendar year as a taxable year, corporations M and N are controlled foreign corporations throughout the period here involved, and neither corporation is a less developed country corporation. The earnings and profits and subpart F income of, and the foreign income taxes paid by, such corporations for 1964 are as follows:

	M	N
Pretax earnings and profits	$500,000	$1,200,000
Foreign income taxes	200,000	400,000
Earnings and profits	300,000	800,000
Subpart F income	150,000	750,000

Apart from his section 951(a) income, A has gross income of $200,600 and $100,000 of deductions attributable to such income. He is required to include $90,000 (0.60 × $150,000) in gross income under section 951(a) with respect to M Corporation and $600,000 (0.80 × $750,000) with respect to N Corporation. A elects to have the provisions of section 962 apply for 1964 and computes his tax as follows:

Tax on amounts included under sec. 951(a):			
Income under sec. 951(a) from M Corporation	$90,000		
Gross-up under secs. 960(a) (1) and 78 ($90,000/ $300,000 × $200,000)	60,000		
Income under sec. 951(a) from N Corporation	600,000		
Gross-up under secs. 960(a) (1) and 78 ($600,000/ $800,000 × $400,000)	300,000		
Taxable income under sec. 11	1,050,000		
Normal tax (0.22 × $1,050,000)		$231,000	
Surtax exemption ([$90,000 + $600,000]/[0.60 × $300,000 + (0.80 × $ 800,000)] × $25,000)	21,036		
Subject to surtax under sec. 11 ($1,050,000 – $21,036)	1,028,964		
Surtax (0.28 × $1,028,964)		288,110	
Tentative U.S. tax		519,110	
Foreign tax credit ($60,000 + $300,000)		360,000	
Total U.S. tax payable on amounts included under sec. 951(a)			$159,110
Tax with respect to other income:			
Gross income		200,600	
Less:			
Personal exemption	600		
Deductions	100,000		
	100,600		
Taxable income		100,000	
Tax with respect to such other taxable income			59,340
Total tax ($159,110 + $59,340)			218,450

[T.D. 6858, 30 FR 13695, Oct. 28, 1965, as amended by T.D. 7413, 41 FR 12640, Mar. 26, 1976]

§ 1.962-2 Election of limitation of tax for individuals.

(a) *Who may elect.* The election under section 962 may be made only by a United States shareholder who is an individual (including a trust or estate).

(b) *Time and manner of making election.* Except as provided in § 1.962-4, a United States shareholder shall make an election under this section by filing a statement to such effect with his return for the taxable year with respect to which the election is made. The statement shall include the following information:

(1) The name, address, and taxable year of each controlled foreign corporation with respect to which the electing shareholder is a United States shareholder and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(2) The amounts, on a corporation-by-corporation basis, which are included in such shareholder's gross income for his taxable year under section 951(a);

(3) Such shareholder's pro rata share of the earnings and profits (determined under § 1.964-1) of each such controlled foreign corporation with respect to which such shareholder includes any amount in gross income for his taxable year under section 951(a) and the foreign income, war profits, excess profits, and similar taxes paid on or with respect to such earnings and profits;

(4) The amount of distributions received by such shareholder during his taxable year from each controlled foreign corporation referred to in subparagraph (1) of this paragraph from excludable section 962 earnings and profits (as defined in paragraph (b)(1)(i) of § 1.962-3), from taxable section 962 earnings and profits (as defined in paragraph (b)(1)(ii) of § 1.962-3), and from earnings and profits other than section 962 earnings and profits, showing the source of such amounts by taxable year; and

(5) Such further information as the Commissioner may prescribe by forms and accompanying instructions relating to such election.

(c) *Effect of election*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph and § 1.962-4, an election under this section by a United States shareholder for a taxable year shall be applicable to all controlled foreign corporations with respect to which such shareholder includes any amount in gross income for his taxable year under section 951(a) and shall be binding for the taxable year for which such election is made.

(2) *Revocation.* Upon application by the United States shareholder, an election made under this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made. The application for consent to revocation shall be made by the United States shareholder's mailing a letter for such purpose to Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224, containing a statement of the facts upon which such shareholder relies in requesting such consent.

[T.D. 6858, 30 FR 13696, Oct. 28, 1965]

§ 1.962-3 Treatment of actual distributions.

(a) *In general.* Section 962(d) provides that the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of an individual United States shareholder under section 951(a) by reason of such shareholder's ownership (within the meaning of section 958(a)) of stock in such corporation and with respect to which amounts an election under § 1.962-2 applies or applied shall, when such earnings and profits are distributed to such shareholder with respect to such stock, notwithstanding the provisions of section 959(a)(1), be included in his gross income to the extent that such earnings and profits exceed the amount of income tax paid by such shareholder under this chapter on the amounts to which such election applies or applied. Thus, when such shareholder receives an actual distribution of section 962 earnings and profits (as defined in paragraph (b)(1) of this section) from a foreign corporation, only the excludable section 962 earnings and profits (as defined in paragraph (b)(1)(i) of this section) may be excluded from his gross income.

(b) *Rules of application.* For purposes of this section—

(1) *Section 962 earnings and profits defined.* With respect to an individual United States shareholder, the term "section 962 earnings and profits" means the earnings and profits of a foreign corporation referred to in paragraph (a) of this section. Such earnings and profits include—

(i) *Excludable section 962 earnings and profits.* Excludable section 962 earnings and profits which are the amount of the section 962 earnings and profits equal to the amount of income tax paid under this chapter by such shareholder on the amounts included in his gross income under section 951(a); and

(ii) *Taxable section 962 earnings and profits.* Taxable section 962 earnings and profits which are the excess of section 962 earnings and profits over the amount described in subdivision (i) of this subparagraph.

(2) *Determinations made separately for each taxable year.* If section 962 earnings and profits attributable to more than one taxable year are distributed by a foreign corporation the determinations under this section shall be made separately with respect to each such taxable year.

(3) *Source of distributions*—(i) *In general.* Except as otherwise provided in this subparagraph, the provisions of paragraphs (a) through (d) of § 1.959-3 shall apply in determining the source of distributions of earnings and profits by a foreign corporation.

(ii) *Treatment of section 962 earnings and profits under § 1.959-3.* For purposes of a section 959(c) amount and year classification under paragraph (b) of § 1.959-3, a distribution of earnings and profits by a foreign corporation shall be first allocated to earnings and profits other than section 962 earnings and profits (as defined in subparagraph (1) of this paragraph) and then to section 962 earnings and profits. Thus distributions shall be considered first attributable to amounts described in paragraph (b)(1) of § 1.959-3 which are not section 962 earnings and profits and then to amounts described in such paragraph (b)(1) which are section 962 earnings and profits (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), secondly to amounts described in paragraph (b)(2) of § 1.959-3 which are not section 962 earnings and profits and then to amounts described in such paragraph (b)(2) which are section 962 earnings and profits (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year), and finally to the amounts described in paragraph (b)(3) of § 1.959-3 (first for the current taxable year and then for prior taxable years beginning with the most recent prior taxable year).

(iii) *Allocation to excludable section 962 earnings and profits.* A distribution of section 962 earnings and profits by a foreign corporation for any taxable year shall be considered first attributable to the excludable section 962 earnings and profits (as defined in subparagraph (1)(i) of this paragraph) and then to taxable section 962 earnings and profits.

(iv) *Allocation of deficits in earnings and profits.* A United States shareholder's pro rata share (determined in accordance with the principles of paragraph (e) of § 1.951-1) of a foreign corporation's deficit in earnings and profits (determined under § 1.964-1) for any taxable year shall be applied in accordance with the provisions of paragraph (c) of § 1.959-3 except that such deficit shall also be applied to taxable section 962 earnings and profits (as defined in subparagraph (1)(ii) of this paragraph).

(4) *Distribution in exchange for stock.* The provisions of this section shall not apply to a distribution of section 962 earnings and profits which is treated as in part or full payment in exchange for stock under subchapter C of chapter 1 of the Internal Revenue Code. The application of this subparagraph may be illustrated by the following example:

Example. Individual United States shareholder A owns 60 percent of the only class of stock in foreign corporation M, the basis of which is $10,000. Both A and M Corporation use the calendar year as a taxable year. In each of the taxable years 1964, 1965, and 1966, M Corporation has $1,000 of earnings and profits and $1,000 of subpart F income. With respect to each such amount, A includes $600 in gross income under section 951(a), makes the election under section 962, and pays a United States tax of $132 (22 percent of $600). Accordingly, A increases the basis of his stock in M corporation under section 961(a) by $132 in each of the years 1964, 1965, and 1966, and thus on December 31, 1966, the adjusted basis for A's stock in M Corporation is $10,396. In 1967, M Corporation is completely liquidated (in a transaction described in section 331) and A receives $13,800, consisting of $1,800 of earnings and profits attributable to the amounts which A included in gross income under section 951(a) in 1964, 1965, and 1966, and $12,000 attributable to the other assets of M Corporation. No amount of the $3,404 gain realized by A on such distribution ($13,800 minus $10,396) may be excluded from gross income under section 959(a)(1). However, section 962(d) will not prevent any part of such $3,404 from being treated as a capital gain under section 331.

(5) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. (a) M, a controlled foreign corporation is organized on January 1, 1963; A and B, individual United States shareholders, own 50 percent and 25 percent, respectively, of the only class of stock in M Corporation. Corporation M, A, and B use the calendar year as a taxable year, and M Corporation is a controlled foreign corporation throughout the period here involved. For the taxable years 1963, 1964, 1965, and 1966, A and B must include amounts in gross income under section 951(a) with respect to M Corporation. For the years 1963, 1965, and 1966, A makes the election under section 962. On January 1, 1967, B sells his 25-percent interest in M Corporation to A; A satisfies the requirements of paragraph (d) of § 1.959-1 so as to qualify as B's successor in interest. As of December 31, 1967, M Corporation's accumulated earnings and profits of $675 (before taking into account distributions made in 1967) applicable to A's interest (including his interest as B's successor in interest) in such corporation are classified under § 1.959-3 and this section for purposes of section 962(d) as follows:

CLASSIFICATION OF EARNINGS AND PROFITS FOR PURPOSES OF SEC. 1.962-3

Year	Sec. 959(c)(1)			Sec. 959(c)(2)			Sec. 959 (c)(3)
	Non-sec. 962 earnings and profits	Excludable sec. 962 earnings and profits	Taxable sec. 962, earnings and profits	Non-sec. 962 earnings and profits	Excludable sec. 962 earnings and profits	Taxable sec. 962 earnings and profits	
1963	$25	$11	$39				
1964	75			$60			$15
1965				75	$33	$117	
1966				50	22	78	
1967							75

(b) During 1967, M Corporation makes three separate distributions to A of $200, $208, and $267. The source of such distributions under § 1.959-3 and this section is as follows:

Distribution	Amount	Year	Classification of distributions under secs. 959 and 962(d)
No. 1	$75	1964	(c)(1) non-sec. 962.
	25	1963	Do.
	11	1963	(c)(1) excludable sec.
	39	1963	962
	50	1966	(c)(1) taxable sec. 962.
			(c)(2) non-sec. 962.
Total	200		
No. 2	22	1966	(c)(2) excludable sec.
	78	1966	962
	75	1965	(c)(2) taxable sec. 962.
	33	1965	(c)(2) non-sec. 962.
			(c)(2) excludable sec. 962.
Total	208		
No. 3	117	1965	(c)(2) taxable sec. 962.
	60	1964	(c)(2) non-sec. 962.
	75	1967	(c)(3).
	15	1964	Do.
Total	267		

(c) A must include $324 in his gross income for 1967. The source of these amounts is as follows:

Distribution	Amount	Year	Classification
No. 1	$39	1963	(c)(1) taxable sec. 962.
No. 2	78	1966	(c)(2) taxable sec. 962.
No. 3	117	1965	Do.
	75	1967	(c)(3).
	15	1964	Do.
Total	324		

(c) *Treatment of shareholder's successor in interest*—(1) *In general.* If a United States person (as defined in § 1.957-4) acquires from any person any portion of the interest in the foreign corporation of a United States shareholder referred to in this section, the rules of paragraphs (a) and (b) of this section shall apply to such acquiring person. However, no exclusion of section 962 earnings and profits under paragraph (a) of this section shall be allowed unless such acquiring person establishes to the satisfaction of the district director his right to such exclusion. The information to be furnished by the acquiring person to the district director with his return for the taxable year to support such exclusion shall include:

(i) The name, address, and taxable year of the foreign corporation from which a distribution of section 962 earnings and profits is received and of all other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(ii) The name and address of the person from whom the stock interest was acquired;

(iii) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(iv) The amount for which an exclusion under paragraph (a) of this section is claimed; and

(v) Evidence showing that the section 962 earnings and profits for which an exclusion is claimed are attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) subject to an election under § 1.962-2, that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder including such amount.

The acquiring person shall also furnish to the district director such other information as may be required by the district director in support of the exclusion.

(2) *Taxes previously deemed paid by an individual United States shareholder.* If a corporate successor in interest of an individual United States shareholder receives a distribution of section 962 earnings and profits, the income, war profits, and excess profits taxes paid to any foreign country or to any possession of the United States in connection with such earnings and profits shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such individual United States shareholder under paragraph (b)(2) of § 1.962-1 and section 960(a)(1) for any prior taxable year.

[T.D. 6858, 30 FR 13696, Oct. 28, 1965]

§ 1.962-4 Transitional rules for certain taxable years.

(a) *Extension of time for making or revoking election.* Paragraphs (b) and (c) of this section provide additional rules with respect to making or revoking an election under section 962 which apply only to a taxable year of a United States shareholder for which the last day prescribed by law for filing his return (including any extensions of time under section 6081) occurs or occurred on or before January 31, 1966.

(b) *Manner of making election not previously made.* If a United States shareholder who has not previously made an election under section 962 for any taxable year referred to in paragraph (a) of this section desires to make such an election, he may do so by filing his return or an amended return for such taxable year together with a statement setting forth the information required under paragraph (b) of § 1.962-2. Such return or amended return and statement shall be filed on or before January 31, 1966.

(c) *Revocation of election previously made.* If a United States shareholder who has made an election under section 962 on or before November 1, 1965, for any taxable year referred to in paragraph (a) of this section desires to revoke such election, he may do so by filing an amended return to which is attached a statement that the election previously made is revoked. Such amended return and statement shall be filed on or before January 31, 1966.

[T.D. 6858, 30 FR 13698, Oct. 28, 1965]

§ 1.963-0 Repeal of section 963; effective dates.

(a) *Repeal of section 963.* Except as provided in paragraphs (b) and (c) of this section, the provisions of section 963 and §§ 1.963-1 through 1.963-7 are repealed for taxable years of foreign corporations beginning after December 31, 1975, and for taxable years of United States shareholders (within the meaning of section 951(b), within which or with which such taxable years of such foreign corporations end.

(b) *Transitional rules for chain or group election*—(1) *In general.* If a United States shareholder (within the meaning of section 951(b) makes either a chain election pursuant to § 1.963-1(e) or a group election pursuant to § 1.963-1(f) for a taxable year of such shareholder beginning after December 31, 1975, then a foreign corporation shall be includible in such election only if—

(i) It has a taxable year beginning before January 1, 1976, which ends within such taxable year of the United States shareholder, and

(ii) It is either—

(A) A controlled foreign corporation or

(B) A foreign corporation by reason of ownership of stock in which such shareholder indirectly owns (within the meaning of section 958(a)(2)) stock in a controlled foreign corporation to which this subparagraph applies.

(2) *Series rule.* If any foreign corporation in a series of foreign corporations is excluded by subparagraph (i) of this paragraph from a chain or group election of a United States shareholder for its taxable year, then any foreign corporation in which the United States shareholder owns stock indirectly by reason of ownership of stock in such excluded corporation shall also be excluded from such elec-

tion to the extent of such indirect ownership regardless of when its taxable year begins.

(3) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. (a) M is a domestic corporation. A, B, D, and E are controlled foreign corporations, and C is a foreign corporation other than a controlled foreign corporation. All five foreign corporations, each have only one class of stock outstanding. M owns directly all of the stock of A, which in turn owns directly all of the stock of B, which in turn owns directly 60 percent of the stock of D, which in turn owns directly all of the stock of E. M also owns directly 40 percent of the stock of C, which in turn owns directly the remaining 40 percent of the stock of D. M is a United States shareholder with respect to no other foreign corporation. M and B each use the calendar year as the taxable year. A, C, D, and E each use a fiscal year ending on November 30 as the taxable year. For calendar year 1976, M may make either a first-tier election with respect to A, a chain election with respect to C and D (to the extent of M's indirect 16-percent stock interest in D by reason of its direct ownership of 40 percent of the stock of C) or a group election with respect to A, C, D (to the extent of such 16-percent stock interest) and E (to the extent of M's indirect 16-percent stock interest in E).

(b) M's indirect 100 percent stock interest in B will be excluded from any chain or group election made by M for calendar year 1976 since B is a controlled foreign corporation which does not have a taxable year beginning before January 1, 1976, which ends within the taxable year of M beginning after December 31, 1975, for which M has made either a chain or group election.

(c) M's indirect 60 percent stock interest through A and B in D and E will be excluded from any chain or group election made by M for calendar year 1976 since such 60 percent interests are indirectly owned by M by reason of its indirect ownership of stock in B, which is a foreign corporation which does not have a taxable year beginning before January 1, 1976, which ends within the taxable year of M beginning after December 31, 1975, for which M has made either a chain or group election.

(d) If C used the calendar year as its taxable year and was therefore excluded from a chain election made with respect to it and D, then D would also be excluded from such an election, since D would then be a foreign corporation in which M owns stock indirectly by reason of ownership of stock in C, which is excluded from such election.

(c) *Deficiency distributions.* The rules relating to deficiency distributions under section 963(e)(2) and § 1.963-6 shall continue to apply to a taxable year beginning after the effective date of the repeal of section 963 in which it is determined that a deficiency distribution must be made for an earlier taxable year for which a United States shareholder made an election to secure the exclusion under section 963 but failed to receive a minimum distribution.

(d) *Special adjustments pursuant to section 963 to be taken into account for taxable years subsequent to the repeal of section 963.* If a United States shareholder of a controlled foreign corporation elects to receive a minimum distribution under section 963 for a taxable year, section 963 and the regulations thereunder may require certain elections and adjustments to be made in subsequent taxable years. These elections and adjustments shall be taken into account for subsequent taxable years as if section 963 were still in effect and no election to receive a minimum distribution were made after the effective date of the repeal of section 963. Examples of these elections and special adjustments include, but are not limited to, the election which may be made pursuant to § 1.963-3(g)(2), relating to the special extended distribution period, and the special adjustments to be made pursuant to § 1.963-4, relating to the minimum overall tax burden test.

[T.D. 7545, 43 FR 19652, May 8, 1978]

§ 1.963-1 Exclusion of subpart F income upon receipt of minimum distribution.

(a) *In general*—(1) *Purpose of section 963.* Section 963 sets forth an exception to section 951(a)(1)(A)(i) by providing that a United States corporate shareholder may exclude from its gross income the subpart F income of a controlled foreign corporation if for the taxable year such shareholder elects such exclusion and, where necessary, receives a distribution of the earnings and profits of such foreign corporation sufficient to bring the aggregate U.S. and foreign income taxes on the pretax earnings and profits of that corporation to a percentage level approaching the U.S. tax rate for such year on the income of a domestic corporation. The election to secure an exclusion under section 963 may be made with respect to a "single first-tier corporation" or a "chain" or "group" of controlled foreign corporations. This section defines the terms "single first-tier corporations," "chains," "group," and certain other terms and prescribes the manner in which such an election is to be made. Section 1.963-2 describes the manner in which the amount of the minimum distribution for any taxable year is to be determined. Section 1.963-3 specifies the distributions counting toward a minimum distribution. Section 1.963-4 sets forth the requirement with respect to a minimum distribution from a chain or group that the overall U.S. and foreign income tax must equal either 90 percent of the U.S. corporate tax rate applied against consolidated pretax and predistribution earnings and profits or, with the application of the special rules set forth in that section, the total U.S. and foreign income taxes which would have been incurred in respect of a pro rata minimum distribution from the chain or group. Section 1.963-5 provides special rules for applying section 963 in certain cases in which the rate of foreign income tax incurred by a foreign corporation varies with the amount of distributions it makes for the taxable year. Section 1.963-6 outlines the deficiency distribution procedure that may be followed if for reasonable cause a U.S. corporate shareholder fails to receive a complete minimum distribution for a taxable year for which it elects the exclusion under section 963. Section 1.963-7 provides transitional rules for the application of section 963 for certain taxable years of U.S. shareholders ending on or before the 90th day after September 30, 1964. Section 1.963-8 provides rules for the determination of the required minimum distribution during the period the § surcharge imposed by section 51 is in effect.

(2) *Conditions for exclusion of subpart F income.* To qualify for an exclusion under section 963 for any taxable year with respect to the subpart F income of a controlled foreign corporation, a corporate United States shareholder must—

(i) Elect such exclusion on or before the last day (including any extensions of time under section 6081) prescribed by law for filing its return of the tax imposed by chapter 1 of the Code for the taxable year;

(ii) Receive, if and to the extent necessary, distributions of the type described in paragraph (a) of § 1.963-3 sufficient in amount to constitute a minimum distribution;

(iii) Incur, in the case of a chain or group election, income tax with respect to such minimum distribution sufficient to satisfy the requirements of paragraph (a) of § 1.963-4, relating to the minimum overall tax burden; and

(iv) Consent, on or before such last day for making the election, to the regulations under section 963 applicable to such taxable year and to any amendments thereof duly prescribed before such last day.

The making of the election under section 963 by filing the return on or before such last day shall constitute the consent to the regulations under such section prescribed before such last day. For an extension of the time for receiving a minimum distribution and making the consent for certain taxable years ending on or before the 90th day after September 30, 1964, see § 1.963-7.

(3) *Subpart F income excluded.* An exclusion under section 963 for a taxable year of a United States shareholder for which the election is made under such section shall apply only to the subpart F income for the taxable year of the single first-tier corporation to which the election applies or of each controlled foreign corporation in the chain or group to which the election applies. Only those amounts attributable to the stock interest to which the election relates may be excluded. Thus, in case of a first-tier election with respect to stock of a controlled foreign corporation owned directly within the meaning of section 958(a)(1)(A), the corporate United States shareholder may not exclude any subpart F income of such foreign corporation which is includible in its gross income under section 951(a)(1)(A)(i) by virtue of its indirect

ownership of stock in such foreign corporation through the operation of section 958(a)(2). Subpart F income of a controlled foreign corporation which is excluded from the gross income of a United States shareholder by reason of the receipt of a minimum distribution to which section 963 applies shall not be considered to be excluded under section 954(b)(1) or section 970(a).

(4) *Affiliated group of corporations.* An affiliated group of domestic corporations which makes a consolidated return under section 1501 for the taxable year shall be treated as a single United States shareholder for purposes of applying section 963 for such year if the common parent corporation in its return for such affiliated group makes any first-tier election, chain election, or group election under section 963 for such affiliated group; in such case, no member of such affiliated group may separately make any first-tier election, chain election, or group election under section 963 for the taxable year. If the common parent of such an affiliated group so making a consolidated return makes no first-tier election, chain election, or group election for such affiliated group, then any member may make a first-tier election, chain election, or group election to the same extent that it could so elect if such affiliated group had not filed a consolidated return; in such case, the affiliated group will not be treated as a single United States shareholder.

(b) *Definitions.* For purposes of section 963 and §§ 1.963-1 through 1.963-8—

(1) *Controlled foreign corporation.* The term "Controlled foreign corporation" shall have the meaning accorded to it by section 957 and the regulations thereunder but shall not include any foreign corporation for a taxable year beginning before January 1, 1963.

(2) *Single first-tier corporation.* The term "single first-tier corporation" means a controlled foreign corporation described in paragraph (d) of this section with respect to which a first-tier election has been made for the taxable year.

(3) *Chain.* The term "chain" means collectively the foreign corporations described in paragraph (e) of this section with respect to which a chain election has been made for the taxable year.

(4) *Group.* The term "group" means collectively the foreign corporations described in paragraph (f) of this section with respect to which a group election has been made for the taxable year.

(5) *First-tier election, etc.* The term "first-tier election" means an election described in paragraph (c)(1)(i)(a) of this section; the term "chain election" means an election described in paragraph (c)(1)(i)(b) of this section; and the term "group election" means an election described in paragraph (c)(1)(ii) of this section.

(6) *Taxable year.* (i) The term "taxable year of a single first-tier corporation," "taxable year of a corporation in a chain," or "taxable year of a corporation in a group," means, respectively, the taxable year of such corporation ending with or within the taxable year of the electing United States shareholder for which is made under paragraph (c)(1) of this section the election establishing it as a single first-tier corporation, a corporation in a chain, or corporation in a group, as the case may be.

(ii) The term "taxable year" when used in reference to a chain or group refers collectively to the respective taxable years of the foreign corporations in such chain or group to which applies the election establishing such chain or group status, such taxable year being, in the case of each respective corporation in the chain or group, such corporation's taxable year ending with or within the taxable year of the electing United States shareholder, whether or not such taxable year of the corporation is the same as that of any other foreign corporation in the chain or group.

(7) *Foreign income tax.* The term "foreign income tax" means income, war profits, and excess profits taxes, and taxes included in the term "income, war profits, and excess profits taxes" by reason of section 903, paid or accrued to a foreign country or possession of the United States and taken into account for purposes of sections 901 through 905. Except in deter-

mining the foreign tax credit under section 901, the term shall not include any tax which is deemed paid by a foreign corporation under section 902(b).

(c) *Election to exclude subpart F income*—(1) *Foreign corporations included in election.* A corporate United States shareholder may for any taxable year exercise the election to secure an exclusion under section 963 either—

(i) (*a*) Separately with respect to any foreign corporation which as to such shareholder is described in paragraph (d) of this section, and/or

(*b*) Separately with respect to the foreign corporation or corporations which as to such shareholder are in a series described in paragraph (e) of this section, except to the extent of any interest (of such shareholder in any such corporation) with respect to which an election has otherwise been made under this subdivision (i); or

(ii) With respect to all foreign corporations which as to such shareholder are described in paragraph (f) of this section.

(2) *Manner of making election.* An election under subparagraph (1) of this paragraph to secure an exclusion under section 963 and the consent to the regulations under such section shall be made for a taxable year by filing with the return for such taxable year—

(i) A written statement stating that such election is made for such taxable year,

(ii) The names of the foreign corporations to which the election applies, the taxable year, country or incorporation, earnings and profits (as determined under paragraph (d) of § 1.963-2), foreign income tax taken into account under paragraph (e) of § 1.963-2, and outstanding capital stock, of each such corporation,

(iii) In case of a group election, the names of all foreign corporations excluded from such group under paragraph (f) (2) and (3) of this section and identifying characterizations for all foreign branches included in, and excluded from, such group under paragraph (f)(4) of this section, together with the authority for such exclusion or inclusion, and

(iv) Such other information relating to the election made as the Commissioner may prescribe by instructions or schedules to support such return.

(3) *Duration of election*—(i) *Year-by-year requirement.* An election under subparagraph (1) of this paragraph to secure an exclusion under section 963 may be made for each taxable year of the United States shareholder but shall be effective only with respect to the taxable year for which made. An election made for any taxable year shall be irrevocable with respect to that taxable year once the period for the making of such election has expired, except to the extent provided by subdivision (ii) of this subparagraph.

(ii) *Revocation or modification of election for reasonable cause*—(*a*) *Conditions under which allowed.* If, after the making of an election under subparagraph (1) of this paragraph, the United States shareholder establishes to the satisfaction of the Commissioner that reasonable cause exists for revocation or modification of such election, it may withdraw that election; change from a group election to first-tier elections and/or chain elections or from a chain election to a first-tier election: change from a first-tier election to a chain election or from first-tier elections and/or chain elections to a group election; or, in the case of a chain or group election, alter the composition of the chain or group by adding or eliminating corporations. The United States shareholder shall be allowed to revoke or modify elections pursuant to this subdivision only once for any taxable year of such shareholder and then only at a time prior to the expiration of the period prescribed by law for making an assessment of the tax imposed by chapter 1 of the Code for such taxable year and for any subsequent taxable year for which the tax liability of such shareholder would be affected by such revocation or modification of election. The Commissioner may, as a condition to such revocation or modification of the election, require a consent by the United States shareholder under section 6501 to extend, for the taxable year and such subsequent years affected by the revocation or modification, the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties.

(*b*) *Nature of reasonable cause.* Reasonable cause shall be deemed to exist for the revocation or modification of an election only if, after the making of such election, a material and substantial change in circumstances affecting the election occurs which reasonably could not have been anticipated when the election was made and which, to a significant degree, was beyond the control of the electing United States shareholder. For example, reasonable cause would exist if the minimum distribution were computed on the basis of a contested foreign income tax asserted by a foreign tax authority which, as a consequence of litigation occurring after the filing of the United States shareholder's return, is refunded, with the result that the United States shareholder is not entitled under the election which was made to an exclusion under section 963.

(*c*) *Request for revocation or modification.* A United States shareholder desiring to revoke or modify the election shall mail to the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C., 20224, a letter requesting such revocation or modification; such letter shall set forth the information required by subparagraph (2) of this paragraph with respect to any new election and the facts and circumstances which the shareholder considers reasonable cause for such revocation or modification. The shareholder shall also consent, if required, to the extension of assessment period referred to in (*a*) of this subdivision and shall furnish such other information as may be required by the Commissioner in support of such request. If the Commissioner is satisfied that reasonable cause exists for the revocation or modification, the United States shareholder shall file an amended return consistent with any new election which is made.

(d) *Corporations to which a first-tier election may apply*—(1) *Includible interest.* A corporate United States shareholder may make a first-tier election for the taxable year only with respect to a single controlled foreign corporation in which it owns stock directly within the meaning of section 958(a)(1)(A) and only with respect to the stock so owned. The election must apply to all of the stock so owned by such shareholder and shall relate only to the subpart F income of such corporation which would otherwise be required to be included in gross income by reason of owning such stock. The shareholder may for the same taxable year make a first-tier election with respect to one or more controlled foreign corporations in which it directly owns stock and not with respect to other controlled foreign corporations in which it directly owns stock.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (*1*). Domestic corporation M directly owns all the one class of stock in each of the controlled foreign corporations A, B, and C. Corporation M may make a first-tier election for a taxable year with respect to any one of corporations A, B, and C; with respect to corporations A and B, respectively; with respect to corporations A and C, respectively; with respect to corporations B and C, respectively; or with respect to corporations A, B, and C, respectively.

Example (*2*). Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A and 20 percent of the one class of stock of controlled foreign corporation B. Corporation A directly owns 80 percent of the stock of B Corporation. All such corporations use the calendar year as the taxable year. For 1964, M Corporation makes a first-tier election with respect to corporations A and B, respectively, and receives a minimum distribution from each. An exclusion under section 963 for 1964 will be allowed for all of A Corporation's subpart F income for such year but only for the amount of B Corporation's subpart F income which M Corporation would (without regard to section 963) be required to include in gross income for such year under section 951(a)(1)(A)(i) by reason of directly owning 20 percent of the stock of B Corporation. Corporation M may not exclude any amount which it would be required (without regard to section 963) to include in gross income under section 951(a)(1)(A)(i) for such year with respect to the subpart F income of B Corporation by reason of its indirect ownership (through the operation of section 958(a)(2)) of 80 percent of the stock of B Corporation, unless M Corporation separately elects such exclu sion and receives a minimum distribution with respect to such interest. See paragraph (e) of this section relating to chain elections.

(e) *Corporations to which a chain election may apply*—(1) *Includible interests.* A Corporate United States shareholder may make a chain election for the taxable year with respect to one or more controlled foreign corporations in any series which includes only one foreign corporation described in subdivision (i), any one or more controlled foreign corporations described in subdivision (ii), and all foreign corporations described in subdivision (iii) of this subparagraph:

(i) A foreign corporation, whether or not a controlled foreign corporation, to the extent of stock owned by such shareholder—

(*a*) Directly (within the meaning of section 958(a)(1)(A)) in such corporation, or

(*b*) Indirectly (through the operation of section 958(a)(2)) by virtue of the direct ownership (within the meaning of section 958(a)(1)(A)) of stock in such corporation by a foreign trust, foreign estate, or foreign partnership, in which such shareholder is a beneficiary or partner;

(ii) To the extent that such shareholder so elects, any controlled foreign corporation to the extent that, by reason of its ownership of stock described in subdivision (i) of this subparagraph, such shareholder indirectly owns within the meaning of section 958(a)(2) stock in such controlled foreign corporation; and

(iii) All foreign corporations, whether or not controlled foreign corporations, by reason (and to the extent) of ownership of stock in which such shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation included in the series by reason of subdivision (ii) of this subparagraph.

Notwithstanding the preceding sentence, a corporate United States shareholder may make a chain election for the taxable year with respect to a single foreign corporation, but only if such foreign corporation is a controlled foreign corporation described in subdivision (i)(*b*) of this subparagraph. The shareholder may for the same taxable year make a chain election with respect to one or more series, and not with respect to other series, to which this subparagraph applies.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns 80 percent of the one class of stock of controlled foreign corporation B. Corporation M may make a chain election with respect to corporations A and B.

Example (2). Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns 80 percent of the one class of stock of controlled foreign corporation B, which in turn directly owns all the one class of stock of controlled foreign corporation C. Corporation M also directly owns 20 percent of the stock of B Corporation. Corporation M may make a chain election either with respect to corporations A and B or with respect to corporations A, B, and C. In either case corporations B and C can be included in the chain only to the extent of M Corporations indirect 80-percent stock interest in such corporations by reason of its direct ownership of 100 percent of the stock of A Corporation. Corporation M may also make a chain election with respect to corporations B and C, in which case the chain would include corporations B and C to the extent of the 20-percent stock interest which M Corporation owns directly in B Corporation, and indirectly owns in C Corporation by reason of its direct ownership of such stock interest in B Corporation.

Example (3). Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns all the one class of stock of controlled foreign corporations B and C. Corporation M may make a chain election either with respect to corporations A, B, and C; or with respect to corporations A and B; or with respect to corporations A and C.

Example (4). Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A and 40 percent of the one class of stock of foreign corporation B, not a controlled foreign corporation. Corporation A directly owns 30 percent of the one class of stock of controlled foreign corporation C, and B Corporation directly owns the remaining 70 percent of the stock of C Corporation. Corporation M may make a chain election with respect to corporations A and C, but in such case C Corporation can be included in the chain only to the extent of M Corporation's indirect 30-percent stock interest in such corporation by reason of its direct ownership of 100 percent of the stock of A Corporation. Corporation M may instead make a chain election with respect to corporations B and C, but in such case C Corporation can be included in the chain only to the extent of M Corporation's indirect 28-percent stock interest in such corporation by reason of its direct ownership of 40 percent of the stock of B Corporation. In the latter case, B Corporation must be included in the chain even though it is not a controlled foreign corporation. Corporation M may also make two chain elections, one with respect to corporations A and C, and the other with respect to corporations B and C, as described above.

Example (5). Domestic corporation M directly owns all the one class of stock of controlled foreign corporation A, which in turn directly owns all the one class of stock of controlled foreign corporation B and 40 percent of the one class of stock of foreign corporation C, not a controlled foreign corporation. Corporation M may make a chain election with respect to corporations A and B. Corporation C may not be included in the chain since M Corporation does not, by reason of its indirect ownership of stock in C Corporation, own stock in any controlled foreign corporation.

Example (6). Domestic corporation M directly owns a 60-percent partnership interest in foreign partnership D and by reason of such interest owns indirectly, within the meaning of section 958(a)(2), 60 percent of the one class of stock of controlled foreign corporation E (all of the stock of which is directly owned by D Partnership) and 60 percent of the one class of stock of controlled foreign corporation F (all the stock of which is also directly owned by D Partnership). By virtue of its direct interest in D Partnership, M Corporation may make a chain election with respect to E Corporation alone or with respect to F Corporation alone. Corporation M may also make two chain elections, one with respect to E Corporation, the other with respect to F Corporation.

(f) *Corporations to which a group election may apply*—(1) *Includible interests.* A corporate United States shareholder may make a group election for the taxable year with respect to a group of foreign corporations which includes, except as provided in subparagraphs (2) and (3) of this paragraph, all of the following corporations:

(i) All controlled foreign corporations in which such shareholder owns stock either directly within the meaning of section 958(a)(1)(A) or indirectly within the meaning of section 958(a)(2), and

(ii) All foreign corporations, whether or not controlled foreign corporations, by reason (and to the extent) of ownership of stock in which such shareholder, indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation described in subdivision (i) of this subparagraph.

A first-tier election or chain election may not be made for any taxable year with respect to any foreign corporation which for such taxable year has been excluded under subparagraph (2) or (3) of this paragraph from a group with respect to which a group election has been made for such year. The application of this subparagraph may be illustrated by the following examples:

Example (1). Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B and is a United States shareholder with respect to no other foreign corporation. M Corporation may make a group election with respect to corporations A and B.

Example (2). Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B, and B Corporation directly owns 80 percent of the one class of stock of controlled foreign corporation C. Corporation M is a United States shareholder only with respect to corporations A, B, and C. If M Corporation makes a group election, it must make the election with respect to corporations A, B, and C.

Example (3). Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B. Corporation A directly owns 70 percent of the one class of stock of controlled foreign corporation C. Corporation B directly owns 40 percent of the one class of stock of foreign corporation D, not a controlled foreign corporation, and D Corporation directly owns 30 percent of the stock of C Corporation. Corporation M is a United States shareholder with respect to no other foreign corporation. If M Corporation makes a group election, it must make the election with respect to corporations A, B, C, and D. Corporation D must be included in the group even though it is not a controlled foreign corporation.

(2) *Less developed country corporations.* If the United States shareholder so elects, it may for any taxable year exclude from a group for purposes of a

group election every controlled foreign corporation which is a less developed country corporation as defined in section 955(c) and § 1.955-5 for the taxable year of such foreign corporation ending with or within such taxable year of the shareholder but only if, by reason of ownership of stock in such foreign corporation, the shareholder does not indirectly own within the meaning of section 958(a)(2) stock in any other controlled foreign corporation which is not a less developed country corporation for its taxable year ending with or within such taxable year of the shareholder. The election under this subparagraph to exclude a less developed country corporation is required to be made with respect to all less developed country corporations of which the electing shareholder is a United States shareholder and which, under the preceding sentence, are eligible to be excluded.

Example. Domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B, not less developed country corporations. Corporation A directly owns all of the one class of stock of controlled foreign corporation C, B Corporation directly owns all the one class of stock of controlled foreign corporation D, and D Corporation directly owns all the one class of stock of controlled foreign corporation E. Corporations C, D, and E are less developed country corporations under section 955(c). Corporation M may make a group election with respect to corporations A, B, C, D, and E; it may also exclude the less developed country corporations and make a group election with respect to corporations A and B only. If E Corporation were not a less developed country corporation, however, neither D Corporation nor E Corporation could be excluded since, by reason of ownership of stock in D Corporation, M Corporation would indirectly own stock in E Corporation, a controlled foreign corporation which is not a less developed country corporation.

(3) *Foreign corporations with blocked foreign income.* If the United States shareholder so elects, it may for any taxable year exclude from a group for purposes of a group election any foreign corporation with respect to which it is established to the satisfaction of the Commissioner that an amount of earnings and profits of such corporation sufficient to constitute its share of a pro rata minimum distribution (as defined in paragraph (a)(2)(i) of § 1.963-4) by the group cannot be distributed to such United States shareholder because of currency or other restrictions or limitations imposed under the laws of any foreign country. If, by reason of ownership of stock in a foreign corporation which is excluded from the group under the preceding sentence, a United States shareholder owns stock in another foreign corporation an amount of whose earnings and profits sufficient to constitute its share of a pro rata minimum distribution by the group cannot be distributed to such United States shareholder through such excluded foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country, such other foreign corporation must also be excluded from the group for purposes of the group election. For purposes of this subparagraph, the determination as to whether earnings and profits cannot be distributed because of currency or other restrictions or limitations imposed under the laws of a foreign country shall be made in accordance with the regulations under section 964(b), except that such restrictions or limitations shall be considered to exist notwithstanding that distributions are made by the foreign corporation in a foreign currency if, assuming the distributee to be the United States shareholder, the distributed amounts would be excludable from the distributee's gross income for the taxable year of receipt under a method of accounting in which the reporting of blocked foreign income is deferred until the income ceases to be blocked.

(4) *Treatment of foreign branches of domestic corporation as foreign subsidiary corporations*—(i) *In general.* If the United States shareholder so elects, all branches (other than a branch excluded under subdivision (iii) of this subparagraph) maintained by such shareholder in foreign countries and possessions of the United States shall be treated, for purposes of applying subparagraph (1) of this paragraph, as wholly owned foreign subsidiary corporations of such shareholder organized under the laws of such respective foreign countries or posses-

sions of the United States. Each branch treated as such a foreign subsidiary corporation shall be included in the group by the United States shareholder making the group election and shall be regarded, for purposes of section 963, as having distributed to such shareholder all of its earnings and profits for the taxable year, irrespective of the statutory percentage applied for the taxable year under paragraph (b) of § 1.963-2. As used in this subparagraph, the term "branch" shall mean a permanent organization maintained in a foreign country or a possession of the United States to engage in the active conduct of a trade or business. Whether a permanent organization is maintained in a foreign country or possession of the United States shall depend upon the facts and circumstances of the particular case. As a general rule, a permanent organization shall be considered to be maintained in such country or possession if the United States shareholder maintains therein a significant work force or significant manufacturing, mining, warehousing, sales, office, or similar business facilities of a fixed or permanent nature. If a United States shareholder so operates that it satisfies the branch test with respect to each of several foreign countries or possessions, each such branch shall be treated as a separate wholly owned foreign subsidiary corporation organized under the laws of such country or possession in respect of which it satisfies such test. In no event shall a branch which is treated as a wholly owned foreign subsidiary corporation under this subparagraph be also treated as a less developed country corporation. The term "possession of the United States," as used in this subparagraph, shall be construed to have the same meaning as that contained in paragraph (b)(2) of § 1.957-3.

(ii) *Earnings and profits and taxes of a foreign branch.* The earnings and profits (or deficit in earnings and profits) for a taxable year of a branch treated as a wholly owned foreign subsidiary corporation under this subparagraph shall be determined by applying against the gross income (as defined in section 61) of the branch its allowable deductions other than any net operating loss deduction. Any excess of gross income over such deductions shall constitute earnings and profits. Any excess of such deductions over gross income shall constitute a deficit in earnings and profits. For purposes of this subparagraph, the gross income of a branch is that which is produced by the trade or business activities separately conducted by it outside the United States and which is derived from sources without the United States under the provisions of sections 861 through 864 and the regulations thereunder; the allowable deductions of a branch are those which are properly allocable to or chargeable against its gross income and which are allowable under chapter 1 of the Code to the corporation of which it is a branch. Only the foreign income tax allocable to the gross income of the branch shall be considered paid or accrued by such branch. Solely for the purpose of determining under paragraph (c)(2) of § 1.963-2 the effective foreign tax rate of a group which includes a branch treated as a wholly owned foreign subsidiary corporation, the foreign income tax considered paid or accrued by the branch shall be treated as an allowable deduction of such branch even though the United States shareholder chooses to take the benefits of section 901 for the taxable year.

(iii) *Excluded branches.* For purposes of subdivision (i) of this subparagraph, a branch maintained by the United States shareholder in a possession of the United States shall not be treated as a wholly owned foreign subsidiary corporation of the United States shareholder for the taxable year unless such branch would be a controlled foreign corporation (as defined in section 957 and the regulations thereunder) for such taxable year if it were incorporated under the laws of such possession and unless the gross income of such shareholder for such taxable year includes for purposes of the tax imposed by chapter 1 of the Code the income, if any, derived by such shareholder from sources within possessions of the United States, as determined under the provisions of sections 861 through 864 and the regulations thereunder.

(iv) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (1). Throughout 1964, domestic corporation M directly owns all of the one class of stock of controlled foreign corporations A and B. All corporations use the calendar year as the taxable year. During 1964, M Corporation engages in foreign country X in the manufacture and sale of steel tubing and rods, maintaining therein a significant work force and significant manufacturing and sales facilities for such purpose. Corporation M also engages in foreign country Y in the mining and sale of iron ore, maintaining therein a significant work force and substantial mining and sales facilities for such purpose. For 1964, M Corporation may make a group election with respect to corporations A and B and the branches operated in country X and country Y, treating such branches as wholly owned foreign subsidiary corporations. If corporation M elects to include one such branch in the group election, it must include both.

Example (2). Throughout 1964, domestic corporation M directly owns all the one class of stock of controlled foreign corporations A and B. All corporations use the calendar year as the taxable year. During 1964, M Corporation exports tractors to foreign country Z, in which country its sole activities consist of arranging for title to the tractors to pass to the purchasers in that country. Corporation M's only facility in country Z in 1964 is a small rented office, and its work force therein consists only of a few clerical employees. The activites of M Corporation in country Z do not constitute the maintenance of a branch therein for purposes of this subparagraph. Corporation M may make a group election, only with respect to corporations A and B.

[T.D. 6759, 29 FR 13325, Sept. 25, 1964: 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14877, Nov. 3, 1964; T.D. 7100, 36 FR 5335, Mar. 20, 1971]

§ 1.963-2 Determination of the amount of the minimum distribution.

(a) *Application of statutory percentage to earnings and profits.* The amount of the minimum distribution required to be received by a United States shareholder with respect to stock to which the election under paragraph (c) of § 1.963-1 applies for the taxable year in order to qualify for a section 963 exclusion for such year shall be the amount, if any, determined by the multiplication of the statutory percentage applicable for the taxable year by—

(1) In the case of a first-tier election, such shareholder's proportionate share (as determined under paragraph (d)(2) of this section) of the earnings and profits for the taxable year of the single first-tier corporation to which the election relates,

(2) In the case of a chain election, the consolidated earnings and profits (as determined under paragraph (d)(3) of this section) with respect to such shareholder for the taxable year of the chain to which the election relates, or

(3) In the case of a group election, the consolidated earnings and profits (as determined under paragraph (d)(3) of this section) with respect to such shareholder for the taxable year of the group to which the election relates.

For the requirement that the overall United States and foreign income tax incurred in respect of a minimum distribution from a chain or group must equal or exceed either 90 percent of the United States corporate tax rate applied against pretax and predistribution consolidated earnings and profits or, with the application of the special rules set forth therein, must equal or exceed the overall United States and foreign income tax which would have resulted from a pro rata minimum distribution, see paragraph (a)(1) of § 1.963-4.

(b) *Statutory percentage.* The statutory percentage (referred to in paragraph (a) of this section) for the taxable year shall be determined by applying the effective foreign tax rate (as defined in paragraph (c) of this section) for such year with respect to the single first-tier corporation, chain, or group, as the case may be, against—

(1) The table set forth in section 963(b)(1) in the case of an election to secure an exclusion under section 963 for a taxable year of the United States shareholder beginning in 1963 and a taxable year entirely within the surcharge period ending before January 1, 1970.

(2) The table set forth in section 963(b)(2) in the case of an election to secure an exclusion under section 963 for a taxable year of the U.S. shareholder beginning in 1964 or for a tax-

able year of such shareholder beginning in 1969 and ending in 1970 to the extent subparagraph (B) of section 963(b)(3) applies,

(3) The table set forth in section 963(b)(3) in the case of an election to secure an exclusion under section 963 for a taxable year of the U.S. shareholder beginning after December 31, 1964 except a taxable year which includes any part of the surcharge period, or

(4) The table set forth in paragraph (b) of § 1.963-8 in the case of an election to secure an exclusion under section 963 for the calendar year 1970.

Example. Domestic corporation M owns all the one class of stock in controlled foreign corporation A. Corporation M uses the calendar year as its taxable year, and A Corporation uses a fiscal year ending August 31. For 1964, M Corporation makes a first-tier election in order to exclude from gross income for such year the subpart F income of A Corporation for its taxable year ending on August 31, 1964. Although, such election applies to the taxable year of A Corporation beginning on September 1, 1963, the applicable table, for purposes of determining the statutory percentages to be used under paragraph (a) of this section for the taxable year, is that set forth in section 963(b)(2), which relates to taxable years of United States shareholders beginning in 1964. Thus, if for the taxable year of A Corporation ending August 31, 1964, the effective foreign tax rate is 30 percent, A Corporation would have to distribute 72 percent of its earnings and profits for such year in order for M Corporation to be entitled to an exclusion under section 963 for 1964.

(c) *Effective foreign tax rate*—(1) *Single first-tier corporation.* For purposes of section 963 the term "effective foreign tax rate" for a taxable year means, with respect to a single first-tier corporation, the percentage which—

(i) The United States shareholder's proportionate share (as determined under paragraph (e)(1) of this section) of the foreign income tax of such corporation for such taxable year is of—

(ii) The sum of—

(*a*) The United States shareholder's proportionate share (as determined under paragraph (d)(2) of this section) of the earnings and profits of such corporation for such taxable year, and

(*b*) The amount referred to in subdivision (i) of this subparagraph.

(2) *Chain or group of corporations.* For purposes of section 963, the term "effective foreign tax rate" for a taxable year means, with respect to a chain or group, the percentage which—

(i) The consolidated foreign income taxes (as determined under paragraph (e)(2) of this section) of such chain or group with respect to the United States shareholder for such taxable year is of—

(ii) The sum of—

(*a*) The consolidated earnings and profits (as determined under paragraph (d)(3) of this section) of such chain or group with respect to such United States shareholder for such taxable year, and

(*b*) The amount referred to in subdivision (i) of this subparagraph.

(3) *Treatment of United States tax as foreign tax.* For the purpose solely of determining the effective foreign tax rate under this paragraph, if a foreign corporation has pretax earnings and profits attributable to income from sources within the United States for the taxable year upon which it pays United States income tax and if distributions from the earnings and profits of such corporation for such year to the electing United States shareholder with respect to stock to which the election to secure an exclusion under section 963 relates do not entitled such shareholder to the dividends-received deduction under section 245, the amount of the United States income tax shall be taken into account as though such tax were foreign income tax. The amount so treated as foreign income tax shall not exceed 90 percent of an amount determined by multiplying such pretax earnings and profits attributable to income from sources within the United States by a percentage which is the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the United States shareholder.

(d) *Determination of proportionate share of earnings and profits and consolidated earnings and profits*—(1) *Earnings and profits of foreign corporations.* For purposes of §§ 1.963-1 through 1.963-8, the earnings and profits, or deficit in earnings and profits, for the taxable year, of a single first-tier corporation or of a foreign corporation in a chain or group shall be the amount of its earnings and profits for such year, determined under section 964(a) and § 1.964-1 but without reduction for foreign income tax or for distributions made by such corporation, less—

(i) In the case of a foreign corporation included in a chain or group, the amount of any distributions received (computed without reduction for any income tax paid or accrued by such corporation with respect to such distributions) by such corporation during its taxable year from the earnings and profits (whether or not from earnings and profits of the taxable year to which the election under section 963 applies) of another foreign corporation in the chain or group.

(ii) In the case of every foreign corporation, the amount of foreign income tax paid or accrued by such corporation during its taxable year other than foreign income tax referred to in subdivision (i) and (iii) of this subparagraph, and

(iii) In the case of a foreign corporation included in a chain or group, the foreign income tax paid or accrued by such corporation with respect to distributions from the earnings and profits of any other foreign corporation in the chain or group for the taxable year of such other corporation to which the election under section 963 applies, but only if the U.S. shareholder chooses under this subdivision to take such tax into account in determining the effective foreign tax rate rather than count it toward the amount of the minimum distribution as provided in paragraph (b)(2) of § 1.963-3.

In the event that the foreign income tax of a corporation included in a chain or group depends upon the extent to which distributions are made by such corporation, the amount of foreign income tax referred to in subdivision (ii) of this subparagraph shall, only for purposes of determining the effective foreign tax rate, be the amount which would have been paid or accrued if no distributions had been made. For the rules in other cases involving corporations whose foreign income tax varies with distributions, see § 1.963-5. For the manner of computing the earnings and profits of a foreign branch treated as a wholly owned foreign subsidiary corporation see paragraph (f)(4)(ii) of § 1.963-1.

(2) *Shareholder's proportionate share of earnings and profits*—(i) *Corporation with earnings and profits*—(*a*) *In general.* A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 relates, of the earnings and profits of a foreign corporation (not including a foreign branch described in (*b*) of this subdivision) for its taxable year shall be the share which such shareholder would receive if the total amount of such corporation's earnings and profits, as determined under subparagraph (1) of this paragraph, for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation or is a foreign corporation by reason of the ownership of stock in which the United States shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation.

(*b*) *Foreign branch treated as a foreign subsidiary corporation.* A United States shareholder's proportionate share of the earnings and profits, for the taxable year, of a branch treated as a wholly owned foreign subsidiary corporation and included in a group under paragraph (f)(4) of § 1.963-1 shall be the total earnings and profits of such branch for the taxable year, as determined under paragraph (f)(4)(ii) of such section.

(*c*) *Indirectly held foreign corporations.* If the proportionate share to be determined is of earnings and profits of a foreign corporation the stock of which is owned by the United States shareholder by reason of its ownership of stock (with respect to which the election relates) in another corporation, such shareholder's proportionate share of such earnings and profits for the taxable year shall be determined on the basis of the amount such shareholder would receive from such foreign corporation with respect to stock in such foreign corporation if there were distributed for the taxable year all such earnings and profits, as determined under subparagraph (1) of this paragraph, and of all the earnings and profits of all other corporations through which such earnings and profits must pass in order to be received by such shareholder with respect to the stock to which the election relates. For purposes of the preceding sentence, the amount received by the shareholder from the earnings and profits of a foreign corporation shall be determined without taking into account deductions (whether or not allowable under chapter 1 of the Code) of other foreign corporations through which such earnings and profits are distributed.

(*d*) *More than one class of stock.* If a foreign corporation for a taxable year has more than one class of stock outstanding, the earnings and profits of such corporation for such year which shall be taken into account with respect to any one class of such stock shall be the earnings and profits which would be distributed with respect to such class if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year, on which such corporation is a controlled foreign corporation or is a foreign corporation by reason of the ownership of stock in which the United States shareholder indirectly owns within the meaning of section 958(a)(2) stock in a controlled foreign corporation. If an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962. For example, if a controlled foreign corporation, using the calendar year as its taxable year, has earnings and profits for 1963 of $100 accumulated at December 31, 1963, and an arrearage of $150 for such year in respect of preferred stock, the earnings and profits for 1964 attributable to such arrearage may not exceed $50 ($150 − $100).

(*e*) *Discretionary power to allocate earnings to different classes of stock.* If the allocation of a foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the power ordinarily exercised by the board of directors of a domestic corporation, the allocation of such earnings and profits to such classes shall be made for purposes of this subdivision as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share, unless a different method of allocation of such earnings and profits is made by such body not later than 90 days after the close of such taxable year.

(*f*) *Illustrations.* The application of this subdivision may be illustrated by the following examples:

Example (*1*). Domestic corporation M directly owns 80 percent of the one class of stock of controlled foreign corporation A, which directly owns 60 percent of the one class of stock of controlled foreign corporation B. Each such corporation has earnings and profits of $70 for the taxable year, as determined under subparagraph (1) of this paragraph. Corporation M's proportionate share of the earnings and profits is $56 (0.80 × $70) as to A Corporation and $33.60 (0.80 × 0.60 × $70) as to B Corporation.

Example (*2*). Throughout 1964 controlled foreign corporation A, which uses the calendar year as the taxable year, has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, noncumulative preferred stock with a par value of $100 per share. Corporation A has earnings and profits of $1,000, for 1964, as determined under subparagraph (1) of this paragraph. In such case, $360 (0.06 × $100 × 60) of earnings and profits would be taken into account with respect to the preferred stock and $640 ($1,000 − $360), with respect to the common stock. Thus, if a United States shareholder owns 10 shares of common stock and 30 shares of preferred stock for 1964, its proportionate share of the earnings and profits for such year is $340 ([10/40 × $640] + [30/60 × $360]).

(ii) *Deficit in earnings and profits of a corporation in a chain or group.* A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 relates, of a deficit in earnings and profits of a foreign corporation in a chain or group for a taxable year shall be the portion of such deficit which, if such corporation had earnings and profits for such year as determined under subparagraph (1) of this paragraph and all of such earnings and profits were distributed on the date described in subdivision (i)(*a*) of this subparagraph, the share of such earnings and profits such shareholder would receive bears to the total of the earnings and profits which would be so distributed on such date. For the determination of the deficit of a foreign branch treated as a wholly owned foreign subsidiary corporation and included in a group, see paragraph (f)(4)(ii) of § 1.963-1. A United States shareholder's proportionate share of the deficit of such a branch shall be the total deficit of such branch for the taxable year.

(iii) *Controlled foreign corporation for part of year.* If—

(*a*) Stock in a foreign corporation is owned within the meaning of section 958(a) by a United States shareholder on the last day in the taxable year of such corporation for which such corporation is a controlled foreign corporation to which applies an election by such shareholder to secure an exclusion under section 963 with respect to such stock, or

(*b*) Stock in a foreign corporation which is not a controlled foreign corporation is owned within the meaning of section 958(a) by a United States shareholder on the last day in the taxable year of such corporation on which another foreign corporation (which, by reason of the stock so owned, is owned by such shareholder within the meaning of section 958(a)) is a controlled foreign corporation to which applies an election by such shareholder to secure an exclusion under section 963 with respect to such stock,

the earnings and profits of such foreign corporation for the taxable year which are taken into account in determining such shareholder's proportionate share thereof shall be an amount of such earnings and profits, determined as provided in subparagraph (1) of this paragraph, which bears to the total of such earnings and profits the same ratio which the part (computed on a daily basis) of such year during which such corporation is a controlled foreign corporation (or, in case such corporation is not a controlled foreign corporation, during which such other corporation is a controlled foreign corporation) bears to the total taxable year. If the United States shareholder by sufficient records and accounts establishes to the satisfaction of the district director the gross income received or accrued, and the deductions paid or accrued, for the part of such year during which such corporation is a controlled foreign corporation (or, in case such corporation is not a controlled foreign corporation, during which such other corporation is a controlled foreign corporation), the amount of earnings and profits based on such records and accounts may be used in lieu of the amount determined under the preceding sentence. The application of this subdivision may be illustrated by the following examples:

Example (1). Domestic corporation M on June 30, 1963, purchases 60 percent of the one class of stock of A Corporation which on July 1 becomes a controlled foreign corporation and remains such throughout the remainder of 1963. Both corporations use the calendar year as the taxable year. Corporation M makes a first-tier election with respect to A Corporation. For 1963, A Corporation has $100 of earnings and profits, as determined under subparagraph (1) of this paragraph. Corporation M's proportionate share of such earnings and profits for 1963 is $30.25 (0.60×[184/365×$100]).

Example (2). (a) Throughout 1963 domestic corporation M directly owns 20 percent of the one class of stock of foreign corporation A, not a controlled foreign corporation at any time, which directly owns 50 percent of the one class of stock of foreign corporation B, which becomes a controlled foreign corporation on July 1, 1963, and remains such throughout the remainder of 1963. All such corporations use the calendar year as the taxable year. Each of corporations A and B has earnings and profits for 1963 of $100, as determined under subparagraph (1) of this paragraph. Corporation M makes a chain election for 1963 with respect to corporations A and B. Corporation M's proportionate share of the earnings and profits of A Corporation for 1963 is $10.08 (0.20×[184/365×$100]). Corporation M's proportionate share of the earnings and profits of B Corporation for 1963 is $5.04 (0.20×0.50×[184/365×$100]).

(b) If B Corporation had been a controlled foreign corporation throughout 1963, M Corporation's proportionate share of the earnings and profits of corporations A and B for 1963 would have been $20 (0.20 × $100) and $10 (0.20 × 0.50 × $100), respectively.

(c) If corporations A and B had each been a controlled foreign corporation only for the period of January 1, 1963, through June 30, 1963, M Corporation's proportionate share of the earnings and profits of such corporations would have been $9.92 (0.20 × [181/365 × $100]) and $4.98 (0.20 × 0.50 × [181/365 × $100]), respectively.

(d) If A Corporation had been a controlled foreign corporation throughout 1963 or during the period of July 1, 1963, through December 31, 1963, but B Corporation had been a controlled foreign corporation only during the period of January 1, 1963, through June 30, 1963, M Corporation's proportionate share of the earnings and profits of such corporations would have been $20 (0.20 × $100) and $4.96 (0.20 × 0.50 × [181/365 × $100]), respectively.

(3) *Consolidated earnings and profits with respect to United States shareholder.* The consolidated earnings and profits of a chain or group with respect to any United States shareholder for the taxable year shall be the sum of such shareholder's proportionate shares of the earnings and profits, and of the deficit in earnings and profits, determined under subparagraph (2) of this paragraph, for such year of all foreign corporations, whether or not controlled foreign corporations, in such chain or group.

(e) *Foreign income taxes used in determining effective foreign tax rate.* For purposes of determining the effective foreign tax rate under paragraph (c) of this section—

(1) *Shareholder's proportionate share of taxes of a foreign corporation.* The foreign income tax of a foreign corporation for a taxable year shall consist of the foreign income tax referred to in paragraph (d)(1)(ii) of this section with respect to such year and, if the United States shareholder chooses to take the foreign income tax described in paragraph (d)(1)(iii) of this section into account in determining the effective foreign tax rate of a chain or group which includes such foreign corporation, the foreign income tax referred to in such paragraph with respect to such year. A United States shareholder's proportionate share, with respect to stock to which the election to secure an exclusion under section 963 applies, of the foreign income tax of such foreign corporation for a taxable year shall be the same proportion of such foreign income tax that such shareholder's proportionate share (as determined under paragraph (d)(2)(i) of this section) of the earnings and profits of such corporation for such year bears to the total earnings and profits of such corporation for such year. A United States shareholder's proportionate share of the foreign income tax, for the taxable year, of a branch treated as a wholly owned foreign subsidiary corporation and included in a group under paragraph (f)(4) of § 1.963-1 shall be the total foreign income tax of such branch for the taxable year.

(2) *Consolidated foreign income taxes with respect to United States shareholder.* The consolidated foreign income taxes of a chain or group with respect to a United States shareholder for the taxable year of such chain or group shall be the sum of such shareholder's proportionate shares (as determined under subparagraph (1) of this paragraph) of the foreign income tax of all foreign corporations, whether or not controlled foreign corporations, in such chain or group.

(3) *Taxes paid by foreign corporation on distributions received during its distribution period.* If a distribution received by a foreign corporation in a chain or group from another foreign corporation in such chain or group after the close of the recipient's taxable year but during its distribution period for such year is allocated to the earnings and profits of such recipient corporation for such year under paragraph (c)(2) of § 1.963-3, then any foreign income tax paid or accrued by such recipient corporation on such distribution shall be treated as paid or accrued for such taxable year.

(f) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). For 1966, domestic corporation M makes a first-tier election with respect to controlled foreign corporation A, 80 percent of the one class of stock of which M Corporation owns directly. Both corporations use the calendar year as the taxable year. For 1966, A Corporation has earnings and profits (before reduction for foreign income tax) of $100 with respect to which it pays foreign income tax of $30. Its earnings and profits are $70 ($100 - $30). Corporation M's proportionate share of such earnings and profits is $56 (0.80 × $70), and its proportionate share of the foreign income tax is $24 ($56/$70 × $30). The effective foreign tax rate is 30 percent ($24/[$56 + $24]). Based on such effective foreign tax rate, the statutory percentage under section 963(b)(3) for 1966 is 69 percent. Thus, the amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is a dividend of $38.64 (0.69 × $56).

Example (2). For 1966, domestic corporation M makes a first-tier election with respect to controlled foreign corporation A, all of whose one class of stock M Corporation owns directly. Both corporations use the calendar year as the taxable year. For 1966, A Corporation has earnings and profits (before reduction for income tax) of $100, of which $40 is attributable to income from sources within the United States on which $12 United States income tax is paid. The foreign country in which A Corporation is incorporated imposes an income tax at 30 percent on the $100 but allows a credit against its tax for the $12 of United States income tax, so that it imposes a net foreign income tax of $18 for 1966. In determining the effective foreign tax rate of A Corporation for 1966, such $12 of United States income tax may be treated as foreign income tax to the extent it does not exceed $17.28 ($40 × 0.90 × 0.48). Corporation A has earnings and profits of $70 for 1966. Although A Corporation's effective foreign tax rate for 1966 is 30 percent, determined by dividing $30 by the sum of $70 plus $30, none of the United States tax which is taken into account in determining such rate shall be treated as foreign income tax for purposes of determining the foreign tax credit of M Corporation under section 902. Based on such effective foreign tax rate, the statutory percentage under section 963(b)(3) for 1966 is 69 percent. Thus, the amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is a dividend of $48.30 (0.69 × $70).

Example (3). Domestic corporation M directly owns throughout 1966, 60 percent of the one class of stock of controlled foreign corporation A, not a less developed country corporation under section 902(d), which has for 1966 earnings and profits of $70 (all of which is attributable to subpart F income) after having paid foreign income tax of $30. Both corporations use the calendar year as the taxable year. Corporation A is created under the laws of a foreign country which imposes a 6-percent dividend withholding tax. Corporation M would be required, but for section 963, to include $42 (0.60 × $70) of A Corporation's subpart F income in gross income under section 951(a)(1)(A)(i). For 1966, however, M Corporation makes a first-tier election with respect to A Corporation. Since the tax withheld on distributions made by A Corporation is considered to have been paid by M Corporation, the effective foreign tax rate applicable to A Corporation for 1966 is only 30 percent, the percentage which such $30 of foreign income tax is of $100 (the sum of $30 plus $70). Thus, the statutory percentage under section 963(b) for 1966 is 69 percent. The amount of the minimum distribution which M Corporation must receive from A Corporation's 1966 earnings and profits is the distribution M Corporation will receive if A Corporation distributes 69 percent of its earnings and profits for 1966. Thus, if M Corporation receives a distribution of 69 percent of its proportionate share of such earnings and profits or $28.98 (0.69 × 0.60 × $70), it may exclude from gross income for 1966 $42 otherwise required to be included in gross income under section 951(a)(1)(A)(i) and will determine its income tax, assuming no other income and no surtax exemption under section 11(c), as follows:

Dividend	$28.98
Gross-up under sec. 78 ($28.98/ $70 × $30)	12.42
Taxable income	41.40
U.S. tax before foreign tax credit ($41.40 × 0.48)	19.87
Foreign tax credit ($12.42 + [0.06 × $28.98])	14.16
U.S. tax payable	5.71

Example (4). (a) For 1966 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all of whose one class of stock it directly owns, and controlled foreign corporation B all of whose one class of stock is directly owned by A Corporation. Both foreign corporations are subject to a foreign income tax at a flat rate of 30 percent, and all corporations use the calendar year as a taxable year. For 1966, B Corporation has pretax earnings and profits of $100 and distributes $51.50. For 1966, A Corporation has pretax earnings and profits of $151.50, consisting of $100 from selling activities and $51.50 received as a distribution from B Corporation, upon which it pays a foreign income tax of $45.45 (i.e., 30 percent of $151.50).

(b) Corporation M chooses under paragraph (d)(1)(iii) of this section to take the foreign tax paid by A Corporation on the dividend received from B Corporation into account in determining the effective foreign tax rate of the chain rather than count it toward the amount of the minimum distribution. Thus, to determine consolidated earnings and profits of the chain for 1966. A Corporation's pretax earnings and profits of $151.50 are first reduced by the intercorporate dividend of $51.50 received from B Corporation so that A Corporation has pretax and predistribution earnings and profits of $100 ($151.50 less $51.50). Corporation A's pretax and predistribution earnings and profits of $100 are then reduced by the foreign income tax of $30 (30 percent of $100) paid on such earnings and profits, resulting in predistribution earnings and profits of $70 ($100 less $30). Since M Corporation chooses to count toward the effective foreign tax rate, rather than toward the minimum distribution, A Corporation's foreign income tax of $15.45 (0.30 × 51.50) imposed on the dividend received from B Corporation, such predistribution earnings and profits of $70 of A Corporation are further reduced by such $15.45 of tax to $54.55 ($70 − $15.45). Corporation B, having received no dividends from any other corporation in the chain, has predistribution earnings and profits of $70 ($100 less foreign income tax of $30).

(c) The consolidated earnings and profits of the chain for 1966 are $124.55 ($54.55 + $70). The consolidated foreign income taxes for such year are $75.45 ($30 + $15.45 + $30). The effective foreign tax rate of the chain for 1966 is 37.73 percent ($75.45/[$124.55 + $75.45]). The statutory percentage for 1966 under section 963(b)(3) is 51 percent. Thus, the amount of the minimum distribution which M Corporation must receive from the 1966 consolidated earnings and profits of the chain is $63.52 (0.51 × $124.55).

Example (*5*). The facts are the same as in example (4) except that M Corporation does not choose under paragraph (d)(1)(iii) of this section to take into account, in determining the effective foreign tax rate, the foreign income tax of $15.45 paid by A Corporation on the distribution of $51.50 received from B Corporation. In such case, the consolidated earnings and profits of the chain are $140 ($70 + $70) and the consolidated foreign income taxes are $60 ($30 + $30), the latter amount being determined without taking into account A Corporation's foreign income tax of $15.45 on the distribution of $51.50 received from B Corporation. The effective foreign tax rate for 1966 is 30 percent ($60/[$140 + $60]), and the statutory percentage under section 963(b) is 69 percent. Thus, the amount of the minimum distribution which must be made from the 1966 consolidated earnings and profits of the chain is $96.60 (0.69 × $140). For the counting of such $15.45 of A Corporation's tax toward the $96.60 amount of the minimum distribution, see paragraph (b)(2) of § 1.963-3.

Example (*6*). For 1966 domestic corporation M directly owns the following percentages of the one class of stock of the following controlled foreign corporations in respect of which it makes a group election: 80 percent of A Corporation, 60 percent of B Corporation, and 70 percent of C Corporation. All corporations use the calendar year as the taxable year; none of the foreign corporations is a less developed country corporation under section 902(d). Each foreign corporation makes distributions during 1966. The consolidated earnings and profits, and the consolidated foreign income taxes, of the group for 1966 with respect to M Corporation, and the amount of the minimum distribution which M Corporation must receive, are determined as follows, based on the earnings and profits and foreign income tax shown in the following table:

	Controlled foreign corporations		
	A	B	C
Predistribution and pretax earnings and profits	$100	$100	$100.00
Foreign income tax	15	25	35.00
Predistribution earnings and profits	85	75	65.00
M Corporation's proportionate share of earnings and profits:			
(0.80 × $85)	68		
(0.60 × $75)		45	
(0.70 × $65)			45.50
Consolidated earnings and profits with respect to M Corporation ($68 + $45 + $45.50)			158.50
M Corporation's proportionate share of foreign income tax:			
($15 × [$68/$85])	12		
($25 × [$45/$75])		15	
($35 × [$45.50/$65])			24.50
Consolidated foreign income taxes with respect to M Corporation ($12 + $15 + $24.50)			51.50

The effective foreign tax rate for 1966 is 24.5 percent ($51.50/[$158.50 + $51.50]) and the statutory percentage under section 963(b)(3) for such year is 76 percent. Thus, the amount of the minimum distribution which M Corporation must receive from the 1966 consolidated earnings and profits of the group is $120.46 (0.76 × $158.50).

Example (*7*). (a) For 1966 domestic corporation M makes a chain election with respect to the following controlled foreign corporations: A Corporation, 80 percent of whose one class of stock M Corporation owns directly; B Corporation, 60 percent of whose one class of stock is directly owned by A Corporation; and C Corporation, 70 percent of whose one class of stock is directly owned by B Corporation. All corporations use the calendar year as the taxable year; none of the foreign corporations is a less developed country corporation under section 902(d). The predistribution and pretax earnings and profits of each foreign corporation are $100. Each foreign corporation pays a flat rate of foreign income tax on all income computed without reduction for dividends paid and determined by including dividends received. Such rate is 15 percent for A Corporation, 25 percent for B Corporation, and 35 percent for C Corporation. Corporation C distributes $65, and B Corporation distributes $100, for 1966. Corporation M chooses under paragraph (d)(1)(iii) of this section to count toward the effective foreign tax rate, rather than toward the amount of the minimum distribution, the foreign income tax paid by corporations A and B, respectively, on distributions received from corporations B and C, respectively.

(b) The consolidated earnings and profits, and the consolidated foreign income taxes, of the chain, and the amount of the minimum distribution for 1966, with respect to M Corporation are determined as follows:

	Controlled foreign corporations			
	A	B	C	Total
Pretax earnings and profits	$160.00	$145.50	$100.00	
Reduction for intercorporate dividends:				
(0.60 × $100)	60.00			
(0.70 × $65)		45.50		
Pretax and predistribution earnings and profits	100.00	100.00	100.00	
Reduction for foreign income tax on such pretax and predistribution earnings and profits:				
(0.15 × $100)	15.00			
(0.25 × $100)		25.00		
(0.35 × $100)			35.00	
Predistribution earnings and profits	85.00	75.00	65.00	
Reduction for foreign income tax on intercorporate distributions of 1966 earnings and profits:				
(0.15 × $60)	9.00			
(0.25 × $45.50)		11.38		
	76.00	63.62	65.00	
Consolidated earnings and profits with respect to M Corporation:				
(0.80 × $76)	60.80			
(0.80 × 0.60 × $63.62)		30.54		
(0.80 × 0.60 × 0.70 × $65)			21.84	$113.18
Consolidated foreign income taxes with respect to M Corporation:				
($60.80/$76 × [$15 + $9])	19.20			
($30.54/$63.62 × [$25 + $11.38])		17.46		
($21.84/$65 × $35)			11.76	$48.42
Effective foreign tax rate ($48.42/[$113.18 + $48.42])				29.96%
Statutory percentage under section 963(b)				69%
Amount of minimum distribution which M Corporation must receive from 1966 consolidated earnings and profits (0.69 × $113.18), no amount of the tax on intercorporate distributions being counted toward the minimum distribution				$78.0

Example (8). The facts are the same as in example (7) except that M Corporation does not choose under paragraph (d)(1)(iii) of this section to take into account, in determining the effective foreign tax rate, the foreign income tax paid by the recipient corporations on the intercorporate distributions. The consolidated earnings and profits, the consolidated foreign income taxes, of the chain, and the amount of the minimum distribution which M Corporation must receive, for 1966 are determined as follows:

	Controlled foreign corporations			
	A	B	C	Total
Pretax earnings and profits	$160.00	$145.50	$100.00	
Reduction for intercorporate dividends:				
(0.60 × $100)	60.00			
(0.70 × $65)		45.50		
Pretax and predistribution earnings and profits	100.00	100.00	100.00	
Reduction for foreign income tax on such pretax and predistribution earnings and profits:				
(0.15 × $100)	15.00			

	Controlled foreign corporations			
	A	B	C	Total
(0.25 × $100)		25.00		
(0.35 × $100)			35.00	
Predistribution earnings and profits	85.00	75.00	65.00	
Consolidated earnings and profits with respect to M Corporation:				
(0.80 × $85)	68.00			
(0.80 × 0.60 × $75)		36.00		
(0.80 × 0.60 × 0.70 × $65)			21.84	$125.84
Consolidated foreign income taxes with respect to M Corporation:				
($68/$85 × $15)	12.00			
($36/$75 × $25)		12.00		
($21.84/$65 × $35)			11.76	$35.76
Effective foreign tax rate ($35.76/[$125.84 + $35.76])				22.13%
Statutory percentage under sec. 963(b)				76%
Amount of minimum distribution to be made from 1966 consolidated earnings and profits with respect to M Corporation: (0.76 × $125.84)				$95.64
Foreign income tax on intercorporate distributions of 1966 earnings and profits which is counted toward the minimum distribution (see § 1.963-3(b)(2)):				
($68/$85 × [0.15 × $60])	7.20			
($36/$75 × [0.25 × $45.50])		5.46		$12.66
Amount of minimum distribution which M Corporation must actually receive from the chain ($95.64 – $12.66)				$82.98

[T.D. 6759, 29 FR 13329, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14877, Nov. 3, 1964; T.D. 7100, 36 FR 5335, Mar. 20, 1971]

§ 1.963-3 Distributions counting toward a minimum distribution.

(a) *Conditions under which earnings and profits are counted toward a minimum distribution*—(1) *In general.* A distribution to the United States shareholder by a single first-tier corporation or by a foreign corporation included in a chain or group shall count toward a minimum distribution for the taxable year of such shareholder to which the election under section 963 relates only to the extent that—

(i) It is received by such shareholder during such year or within 180 days thereafter,

(ii) It is a distribution of the type described in paragraph (b) of this section,

(iii) Under paragraph (c) of this section, it is deemed to be distributed from the earnings and profits of the foreign corporations for the taxable year of such corporation to which the election relates, and

(iv) Such shareholder chooses to include it in gross income for the taxable year of such shareholder to which the election relates notwithstanding that such distribution, by reason of its receipt after the close of such year, would ordinarily be includible in the gross income of a subsequent year.

Amounts taken into account under this subparagraph as gross income of the United States shareholder for the taxable year to which the election relates shall not be considered to be includible in the gross income of such shareholder for a subsequent taxable year. For purposes of determining the foreign tax credit under sections 901 through 905, foreign income tax paid or accrued by such shareholder on or with respect to such amounts shall be treated as paid or accrued during the taxable year of such election.

(2) *Distributions made prior to acquisition of stock.* A United States shareholder which owns within the meaning of section 958(a) stock in a foreign corporation with respect to which such shareholder elects to secure an exclusion under section 963 for the taxable year may count toward the minimum distribution any distribution made with respect to such stock, and before its acquisition by the United States shareholder, to any other domestic corporation not exempt from income tax under chapter 1 of the Code, to the extent that such distribution is made out of the United States shareholder's propor-

tionate share, as determined under paragraph (d)(2) of § 1.963-2, of such corporation's earnings and profits for the taxable year and would have counted toward a minimum distribution if it had been distributed to such United States shareholder. The application of this subparagraph may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, which uses the calendar year as the taxable year, has for 1963 $100 of earnings and profits and 100 shares of only one class of stock outstanding. Domestic corporation M, not exempt from income tax under chapter 1 of the Code, directly owns all of such shares during the period from January 1, 1963, through June 30, 1963. On June 30, 1963, M Corporation transfers all of such shares to domestic corporation N, which owns them throughout the remainder of 1963 and elects to secure an exclusion under section 963 for such year with respect to the subpart F income of A Corporation. During June 1963, M Corporation receives a dividend of $75 from A Corporation, which would count toward a minimum distribution if it had been distributed to N Corporation for such year. Corporation N's proportionate share of the earnings and profits of A Corporation for 1963 is $100; N Corporation may count toward a minimum distribution for 1963 the entire dividend of $75 paid to M Corporation.

Example (2). The facts are the same as in example (1) except that M is a nonresident alien individual. Since A Corporation is not a controlled foreign corporation from January 1, 1963, through June 30, 1963, N Corporation's proportionate share of the earnings and profits of A Corporation for 1963 is $50.41 ($100 × 184/365), as determined under paragraph (d)(2)(iii) of § 1.963-2. Although $25.41 ($75 − $49.59) of the $75 distribution to M is paid from N Corporation's proportionate share of A Corporation's 1963 earnings and profits, N Corporation may not count toward a minimum distribution any part of the $75 dividend distributed to M, since M is not a domestic corporation.

(b) *Qualifying distributions*—(1) *Amounts not counted toward a minimum distribution.* No distribution received by a United States shareholder shall count toward a minimum distribution for the taxable year with respect to such shareholder to the extent the distribution is excludable from gross income to the extent gain on the distribution is not recognized, or to the extent the distribution is treated as a distribution in part or full payment in exchange for stock. Undistributed amounts required to be included in gross income under section 551 as undistributed foreign personal holding company income or under section 951 as undistributed amounts of a controlled foreign corporation shall not count toward a minimum distribution under section 963. An amount received by a United States shareholder as a distribution which under section 302 or section 331 is treated as a distribution in part or full payment in exchange for stock shall not count toward a minimum distribution even though such amount is includible in gross income under section 1248 as a dividend. For purposes of this subparagraph, any portion of a distribution of earnings and profits which is attributable to an increase in current earnings, invested in United States property which, but for paragraph (e) of this section, would be included in the gross income of the United States shareholder under section 951(a)(1)(B) shall not be treated as an amount excludable from gross income.

(2) *Inclusion of tax on intercorporate distributions.* In the case of a chain or group election, the United States shareholder's proportionate share of the amount of the foreign income tax paid or accrued for the taxable year by a foreign corporation in the chain or group with respect to distributions received by such corporation from the earnings and profits, of another foreign corporation in such chain or group, for the taxable year of such other corporation to which the election relates shall count toward a minimum distribution from such chain or group for the taxable year, but only if the United States shareholder does not choose under paragraph (d)(1)(iii) of § 1.963-2 to take such tax into account in determining the effective foreign tax rate of such chain or group for the taxable year. To the extent that foreign income tax counts toward a minimum distribution under this subparagraph, it shall be applied against and reduce the amount of the minimum distribution required to be received by the United States shareholder, determined without regard to this paragraph.

(c) *Rules for allocation of distributions to earnings and profits for a tax-*

able year. To determine whether a distribution to the United States shareholder by a single first-tier corporation or by a foreign corporation in a chain or group is made from the earnings and profits of such corporation for the taxable year to which the election under section 963 relates, the following subparagraphs shall apply:

(1) *Exception to section 316.* Section 316 shall apply except that a distribution of earnings and profits made by a foreign corporation either to another foreign corporation or to the United States shareholder shall be treated as having been paid from the earnings and profits of the distributing corporation for the taxable year of such corporation to which the election relates only if it is made during its distribution period (described in paragraph (g) of this section) for such year.

(2) *Distributions from other corporations.* The earnings and profits of a foreign corporation shall be determined in accordance with paragraph (d)(1) of § 1.963-2 (applied as though the United States shareholder had chosen under subparagraph (1)(iii) of such paragraph to take the tax described therein into account in determining the effective foreign tax rate) except that, in the case of a chain or group election, a distribution received by a foreign corporation in the chain or group from another foreign corporation in such chain or group shall be taken into account as earnings and profits of the recipient corporation for the taxable year of such recipient corporation to which the election relates but only to the extent that—

(i) The distribution is received by the recipient corporation during the distribution period for the taxable year of such recipient corporation to which the election relates,

(ii) If the distribution had been received by the United States shareholder, it would have constituted a distribution of the type described in paragraph (b) of this section, and

(iii) The distribution is made from the earnings and profits of the distributing corporation for the taxable year of such distributing corporation to which the election relates.

(d) *Year of inclusion in income of foreign corporation and effect upon subpart F income.* To the extent that a distribution to the United States shareholder counting toward a minimum distribution from a chain or group consists of earnings and profits distributed to a foreign corporation in the chain or group after the close of the recipient corporation's taxable year but during its distribution period for such year by another foreign corporation in such chain or group, such amount shall be treated as received by the recipient corporation on the last day of such taxable year and shall not be regarded as foreign personal holding company income (within the meaning of section 553(a) or 954(c)) of such corporation for the taxable year in which such amount is actually received. The extent to which a distribution counting toward a minimum distribution consists of earnings and profits distributed to a foreign corporation in a chain or group shall be determined under the ordering rules of paragraph (b)(3) of § 1.963-4 (applied in each instance as though the United States shareholder had not chosen under paragraph (d)(1)(iii) of § 1.963-2 to take the tax described therein into account in determining the effective foreign tax rate). However, for such purpose, the amount of foreign income tax, if any, which counts toward the minimum distribution shall be determined without regard to paragraph (b)(2) of this section but in accordance with paragraph (b)(3)(iii) of § 1.963-4.

(e) *Distribution of current earnings invested in United States property.* A distribution made by a foreign corporation during its distribution period for a taxable year shall, notwithstanding section 959(c), first be attributed to earnings and profits for such year described in section 959(c)(3) and then to other earnings and profits. For such purposes, earnings and profits of such foreign corporation for such year attributable to amounts which would otherwise be included in gross income of the United States shareholder under section 951(a)(1)(B) for such year shall be treated as earnings and profits to which section 959(c)(3) applies, shall not be excluded from gross income under section 959 (a) or (b), and shall count toward a minimum distribution for such year. See paragraph (c)(1)(v) of § 1.960-1 and paragraph (a) of § 1.960-2.

(f) *Cumulative dividends in arrears.* A distribution in satisfaction of arrearages shall be treated as being made out of earnings and profits of the foreign corporation for the taxable year to which the election under section 963 applies only to the extent the dividend is not attributed, under paragraph (d)(2)(i)(*d*) of § 1.963-2, to the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962. The application of this paragraph may be illustrated by the following example:

Example. For 1963, single first-tier corporation A, which uses the calendar year as the taxable year, has earnings and profits of $50; for 1964, a deficit in earnings and profits of $20; for 1965, earnings and profits of $100; and for 1966, earnings and profits of $240. For each of such years preferred dividends accumulate at the rate of $60; but no dividend is paid until 1966 during which year the current dividend is paid and $180 is distributed toward the arrearages. Of this $180, only $50 ($180 − $130) shall be treated as paid from 1966 earnings and profits.

(g) *Distribution period of a foreign corporation*—(1) *General distribution period.* Except as provided by subparagraph (2) of this paragraph, the distribution period with respect to a foreign corporation for its taxable year shall begin immediately after the close of the distribution period for the preceding taxable year and shall end with the close of the 60th day of the next succeeding taxable year. If no election to secure an exclusion under section 963 applied to the preceding taxable year, the distribution period for the taxable year shall begin with the 61st day of the taxable year.

(2) *Special extended distribution period.* If the United States shareholder of the foreign corporation so elects in statement filed with its return for the taxable year for which the election to secure the exclusion under section 963 is made, the distribution period with respect to such foreign corporation for its taxable year to which the election to secure the exclusion applies shall end with any day which occurs no earlier than the last day of such taxable year of such foreign corporation and no later than the 180th day after the close of such taxable year. The statement shall designate the day so elected as the end of the distribution period.

(h) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). For 1963 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all of whose one class of stock M Corporation directly owns, and controlled foreign corporation B, all of whose one class of stock is directly owned by A Corporation. All such corporations use the calendar year as the taxable year, and the distribution periods of corporations A and B for 1963 coincide. Corporations A and B each have earnings and profits (before distributions) of $100 for 1963. On June 1, 1963, B Corporation distributes earnings and profits of $120, of which $100 is from its earnings and profits for 1963 and $20 is from prior earnings. For 1963, A Corporation pays no income tax and distributes earnings and profits of $150 to M Corporation. Under paragraph (c) of this section, such $150 is allocated to A Corporation's earnings and profits of $200 for 1963, consisting of its total earnings and profits for that year of $220 less the $20 received as a distribution from B Corporation's prior earnings.

Example (2). Domestic corporation M directly owns all of the one class of stock of controlled foreign corporation A. Both corporations use the calendar year as the taxable year, and A Corporation's taxable year and its distribution period for 1963 coincide. For 1963, $50 is included in the gross income of M Corporation under section 951(a)(1)(B) as A Corporation's increase in earnings invested for such year in United States property. For 1964, M Corporation makes a first-tier election with respect to A Corporation. For 1964, A Corporation has earnings and profits of $100, including $10 attributable to an increase in earnings invested for such year in United States property. During 1964, A Corporation distributes earnings and profits of $80 to M Corporation. Without regard to paragraph (e) of this section, $10 of this distribution is attributable under section 959(c)(1) to A Corporation's 1964 earnings and profits required to be included in M Corporation's gross income under section 951(a)(1)(D). Pursuant to paragraph (e) of this section, however, the entire distribution of $80 counts toward a minimum distribution for 1964 and is considered to be from earnings and profits of A Corporation for 1964 described in section 959(c)(3). Thus the entire distribution of $80 is included in M Corporation's gross income as a dividend and the foreign tax credit in respect of such amount is determined in accordance with section 902 as modified by the regulations under section 963. On the other hand, if A Corporation made no distributions for 1964, no part of the $10 of A Corporation's increase in earnings invested in United States property for such year would count toward a minimum distribution for any other year but would be included in the gross income for M Corporation for 1964 under section 951(a)(1)(B), and the foreign tax credit in respect of such amount would be determined in accordance with § 1.960-1.

Example (*3*). For 1964 domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which is owned directly by M Corporation, and controlled foreign corporation B, all the one class of stock of which is owned directly by A Corporation. Corporation M makes no election under section 963 for 1963 or 1965. Corporations M and B use the calendar year as the taxable year, and A Corporation uses for its taxable year a fiscal year ending on September 30. Corporation M elects to have the distribution period for each controlled foreign corporation end on March 29, 1965, such date being the 180th day after the close of A Corporation's taxable year ending on September 30, 1964. Corporation A's distribution period for its taxable year ending on September 30, 1964, begins on November 30, 1963, the 61st day of such taxable year. The distribution period of B Corporation for 1964 begins on March 1, 1964, the 61st day of such taxable year. A distribution counting toward a minimum distribution for 1964 may be made from the earnings and profits of B Corporation only if the amount thereof is distributed by B Corporation to A Corporation, and in turn by A Corporation to M Corporation, during the period of March 1, 1964, through March 29, 1965.

Example (*4*). The facts are the same as in example (3), except that for their taxable years ending in 1964, corporations A and B each have earnings and profits (before distributions) of $100. On March 10, 1965, B Corporation distributes to A Corporation a dividend of $80 upon which A Corporation incurs foreign income tax at the rate of 10 percent. On March 15, 1965, A Corporation distributes to M Corporation a dividend of $50. Corporation M chooses to take into account as gross income for 1964 from such distribution only $40. For purposes of applying this section, the distribution counting toward a minimum distribution is $44.44, consisting of the $40 of earnings and profits actually received by M Corporation plus the $4.44 ($40/$72 × $8) of foreign income tax incurred by A Corporation attributable thereto; A Corporation is deemed to have received $44.44 ($40 ÷ 0.90) of the distribution from B Corporation on September 30, 1964, the last day of the taxable year of A Corporation to which the election relates; and the foreign personal holding company income derived by A Corporation for its taxable year ending in 1965 from the distribution from B is only $35.56 ($80 − $44.44). Assuming that no exceptions, exclusions, or exemptions were applicable, subpart F income would be realized by A Corporation for its taxable year ending on September 30, 1965, upon the distribution by B Corporation to A Corporation, but only in the amount of $32 ($35.56 less a deduction under section 954(b)(5) for taxes of $3.56).

[T.D. 7100, 36 FR 10860, June 4, 1971; 36 FR 11924, June 23, 1971; as amended by T.D. 7334, 39 FR 44214, Dec. 23, 1974]

§ 1.963-4 Limitations on minimum distribution from a chain or group.

(a) *Minimum overall tax burden*—(1) *In general.* Notwithstanding the fact that distributions of the type described in paragraph (a) of § 1.963-3 are made by a chain or group to the United States shareholder in an amount sufficient to constitute a minimum distribution for the taxable year of such shareholder to which the chain or group election relates, no exclusion shall be allowable under section 963 to such shareholder with respect to such chain or group for such year unless—

(i) Without applying the special rules set forth in paragraphs (b) and (c) of this section, the overall United States and foreign income tax (as defined in subparagraph (2)(ii) of this paragraph) for the taxable year with respect to the distribution which is made equals or exceeds 90 percent of an amount determined by multiplying the sum of the consolidated earnings and profits (as determined under paragraph (d)(3) of § 1.963-2) and the consolidated foreign income taxes (as determined under paragraph (e)(2) of § 1.963-2) of such chain or group for the taxable year with respect to such shareholder by a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the shareholder, or

(ii) With the application of the special rules set forth in paragraphs (b) and (c) of this section—

(*a*) Such shareholder receives a pro rata minimum distribution (as defined in subparagraph (2)(i) of this paragraph) from such chain or group for such taxable year, or

(*b*) To the extent necessary, the amount of the foreign income tax allowable as a credit for such year under section 901 with respect to the distribution which is made is reduced and credit for the reduction is deferred, as provided in paragraph (c)(3) of this section, so that the overall United States and foreign income tax for the taxable year with respect to such distribution equals or exceeds the lesser of—

(*1*) The overall United States and foreign income tax which would be paid or accrued for such year with respect to a pro rata minimum distribution received by such shareholder from such chain or group for such year, and

(*2*) Ninety percent of an amount determined by multiplying the sum of the consolidated earnings and profits (as determined under paragraph (b)(1) of this section) and the consolidated foreign income taxes (as determined under paragraph (b)(1) of this section) of such chain or group for the taxable year with respect to such shareholder by a percentage which equals the sum of the normal tax rate and the surtax rate (determined without regard to the surtax exemption) prescribed by section 11 for the taxable year of the shareholder.

(2) *Definitions.* For purposes of §§ 1.963-1 through 1.963.8—

(i) *Pro rata minimum distribution.* A pro rata minimum distribution from a chain or group for the taxable year is a distribution of earnings and profits to the United States shareholder, with respect to stock to which the chain or group election relates, which is the statutory percentage (applicable with respect to such chain or group as determined under paragraph (b) of § 1.963-2) of the United States shareholder's proportionate share of the taxable year's earnings and profits of each foreign corporation in such chain or group (determined in accordance with paragraph (d)(2) of § 1.963-2 but without making any deduction under paragraph (d)(1)(iii) of such section).

(ii) *Overall United States and foreign income tax.* The overall United States and foreign income tax for any taxable year of a chain or group with respect to a minimum distribution is the sum of—

(*a*) The consolidated foreign income taxes of the chain or group for such year with respect to the United States shareholder making the chain or group election,

(*b*) Any other foreign income tax paid or accrued by a foreign corporation in the chain or group by reason of the receipt of any distributions counting toward such minimum distribution from such chain or group for that year, and

(*c*) The foreign income tax, if any, and United States income tax paid or accrued by such shareholder upon amounts counting toward such minimum distribution from such chain or group for such year.

Such overall United States and foreign income tax shall be determined with respect to such minimum distribution without taking into account any foreign income tax which is deemed paid for such year under section 904(d), relating to carryback and carryover of excess tax paid. For purposes of this subdivision, the consolidated foreign income taxes of the chain or group shall be determined under paragraph (e)(2) of § 1.963-2, applied without regard to the second sentence of paragraph (d)(1) of that section.

(3) *Taxes paid by foreign corporation on distributions received during its distribution period.* For purposes of determining foreign income tax deemed paid by the United States shareholder for the taxable year under section 902, if a distribution received by a foreign corporation in a chain or group from another foreign corporation in such chain or group after the close of the recipient's taxable year but during its distribution period for such year is allocated to the earnings and profits of such recipient corporation for such year under paragraph (c)(2) of § 1.963-3, any foreign income tax paid or accrued by such recipient corporation on such distribution shall be treated as paid or accrued for such taxable year.

(4) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. (a) Domestic corporation M directly owns all of the one class of stock of foreign corporation A, which in turn directly owns all of the one class of stock of foreign corporation B. Corporation M makes a chain election with respect to A Corporation and B Corporation. All such corporations use the calendar year as the taxable year. Assuming that A Corporation does not incur foreign tax on amounts distributed by B Corporation, the foreign income tax and earnings and profits of corporations A and B, the effective foreign tax rate, and the statutory percentage for 1966, are as follows:

	A	B	Consolidated
Pretax and predistribution earnings and profits	$100	$100	$200
Foreign income tax	20	40	60
Earnings and profits	80	60	140
Effective foreign tax rate ($60/[$140 + $60])			30%
Statutory percentage under sec. 963(b)			69%

(b) Corporation M is entitled for 1966 to exclude its pro rata share of the subpart F income of corporations A and B for such year if it receives from the 1966 consolidated earnings and profits of the chain distributions totaling at least $96.60 (0.69 × $140) and if—

(1) The sum of the consolidated foreign income taxes ($60) of the chain for 1966 and of the United States income tax for 1966 (determined by taking into account the foreign tax credit under section 901 without regard to paragraph (c) of this section) imposed on such distributions equals at least $86.40 (0.90 × 0.48 × $200);

(2) Under the special rules of paragraphs (b) and (c) of this section, the distributions received consist of a distribution from each of corporations A and B which is 69 percent of the earnings and profits for 1966 of such corporation, that is, a distribution of $55.20 (0.69 × $80) from A Corporation and of $41.40 (0.69 × $60) from B Corporation; or

(3) Under the special rules of paragraphs (b) and (c) of this section, the foreign tax credit is reduced and deferred to such an extent that the sum of the consolidated foreign income taxes ($60) of the chain for 1966 and of the United States income tax for 1966 (determined by taking into account the foreign tax credit under section 901 as modified by paragraph (c) of this section) imposed on such distributions equals the lesser of $86.40 (0.90 × 0.48 × $200) and the amount which the sum of such taxes would be if M Corporation were to receive a distribution of $55.20 (0.69 × $80) from the 1966 earnings and profits of A Corporation and $41.40 (0.69 × $60) from the 1966 earnings and profits of B Corporation.

(b) *Special rules for determining earnings and profits and foreign income taxes.* For purposes of determining the minimum overall tax burden under paragraph (a)(1)(ii) of this section, §§ 1.963-2 and 1.963-3 shall apply as modified by the following subparagraphs:

(1) *Exclusion of tax on intercorporate distributions.* The consolidated earnings and profits and consolidated foreign income taxes of a chain or group for the taxable year shall be determined in accordance with § 1.963-2, except that foreign income tax referred to in paragraph (d)(1)(iii) of such section may be taken into account in determining the effective foreign tax rate only—

(i) To the extent that such tax is not deemed paid by the United States shareholder under section 902 (as modified by paragraph (c) of this section) for its taxable year to which the chain or group election relates, or

(ii) If, by taking the tax into account, the effective foreign tax rate with respect to such chain or group, as determined under paragraph (c)(2) of § 1.963-2, exceeds the highest effective foreign tax rate requiring a distribution under section 963(b) for such year of the shareholder.

(2) *Allocation of deficits.* For purposes of determining the amount of each foreign corporation's share of a pro rata minimum distribution from a chain or group for the taxable year and for purposes of determining the foreign tax credit under paragraph (c) of this section of the United States shareholder with respect to any minimum distribution from a chain or group for the taxable year—

(i) *Deficits of foreign corporations.* The total of the United States shareholder's proportionate shares, as determined under paragraph (d)(2)(ii) of § 1.963-2, of the deficit of every foreign corporation in the chain or group having a deficit for the taxable year shall be allocated against and shall reduce such shareholder's proportionate share, as determined under paragraph (d)(2)(i) of § 1.963-2, of the earnings and profits for the taxable year of each other foreign corporation in the chain or group having earnings and profits for such year in an amount which bears to such total of shares of deficit the same ratio which such share of earnings and profits bears to the total of such shareholder's proportionate shares, as so determined, of the earnings and profits of all foreign corporations in the chain or group having earnings and profits for the taxable year.

(ii) *Deficits of foreign branches.* If for the taxable year a group includes under paragraph (f)(4) of § 1.963-1 foreign branches the aggregate of whose allowable deductions (other than any net operating loss deduction) exceeds the aggregate of their gross incomes for the taxable year, determined as provided in paragraph (f)(4)(ii) of such section, the amount of such excess shall be allocated as provided by subdivision (i) of this subparagraph.

(3) *Distributions through a chain or group.* In determining whether and to what extent a distribution for any taxable year has been made out of the earnings and profits of a foreign corporation included in a chain of ownership described in section 958(a) consisting of two or more corporations in a chain or group for the taxable year, the following subdivisions shall apply:

(i) *Allocation first to income received as a distribution.* If any foreign corporation included in the chain or group for the taxable year receives a distribution for such year from another foreign corporation in the chain or group and in turn makes a distribution for the taxable year, the distribution so made shall first be allocated to the earnings and profits, to the extent thereof, attributable to the distribution so received; if distributions are received from more than one other corporation in the chain or group, the distribution made by the recipient corporation shall be apportioned among all such amounts. For purposes of determining whether a distribution is made or received for the taxable year, see paragraph (c) of § 1.963-3.

(ii) *Successive distributions through a chain or group.* If any foreign corporation included in the chain or group for the taxable year distributes an amount from its earnings and profits of such year, the amount so distributed shall be considered to be received from such earnings and profits by the United States shareholder to the extent the amount is distributed by successive distributions made by each other foreign corporation in the chain or group for the taxable year through the chain of ownership described in section 958(a) into the hands of such shareholder.

(iii) *Distribution determined without reduction by taxes of intervening corporations.* If, for the taxable year to which the election to secure an exclusion under section 963 applies, the United States shareholder receives a distribution to which subdivision (ii) of this subparagraph applies, the entire amount distributed by the foreign corporation from such shareholder's proportionate share of its earnings and profits for the taxable year shall, except where taxes referred to in paragraph (d)(1)(iii) of § 1.963-2 are taken into account as provided by subparagraph (1) of this paragraph, count toward a minimum distribution and shall not be reduced for such purpose by an foreign income tax paid or accrued on such amount by another foreign corporation in the chain or group through which such amount is distributed by successive distributions into the hands of such shareholder. The application of this subdivision may be illustrated by the following examples:

Example (1). For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which is directly owned by M Corporation, and controlled foreign corporation B, all the one class of stock of which is directly owned by A Corporation. All corporations use the the calendar year as the taxable year. Corporation M complies with the special rules of this paragraph and paragraph (c) of this section for the taxable year. Corporation A's only income for 1966 is a dividend of $52.50 distributed in such year by B Corporation, on which A Corporation is subject to an income tax of $10.50. The remaining $42 ($52.50 less $10.50) is distributed by A Corporation for 1966 to M Corporation. The full $52.50 distributed by

B Corporation counts toward a minimum distribution by the chain for 1966.

Example (2). For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, all the one class of stock of which it owns directly, and controlled foreign corporation B, all the one class of stock of which A Corporation own directly. All corporations use the calendar year as the taxable year. Corporation M complies with the special rules of this paragraph and paragraph (c) of this section for the taxable year. The predistribution and pretax earnings and profits for 1966 of B Corporation are $100, and of A Corporation, $0. Corporation B pays foreign income tax of $30 and during the year distributes $70. On such $70, A Corporation pays foreign income tax of $14. By applying paragraph (d)(1)(iii) of § 1.963-2, the consolidated foreign income taxes of the chain for 1966 are $44 ($30+$14) and the consolidated earnings and profits of the chain are $56 ($70−$14); in such case, the effective foreign tax rate of the chain for 1966 is 44 percent ($44/[$56+$44]) and thus in excess of the highest effective foreign tax rate requiring a distribution for such year under section 963(b). Since M Corporation may thus take A Corporation's tax of $14 into account, the statutory percentage under section 963(b) for 1966 is zero percent and the amount of the minimum distribution required to be made by the chain is $0.

(c) *Special foreign tax credit rules*—(1) *In general.* In determining the minimum overall tax burden under paragraph (a)(1)(ii) of this section, the foreign tax credit of the United States shareholder with respect to a minimum distribution received for the taxable year from the chain or group shall be determined under the provisions of sections 901 through 905 as modified by § 1.963-3 except that—

(i) Under subparagraph (2) of this paragraph—

(*a*) Taxes of a second-tier corporation making a distribution through a first-tier corporation shall not be averaged with taxes of such first-tier corporation,

(*b*) Taxes of a first-tier corporation or a second-tier corporation on a distribution made through such corporation shall not be averaged with such corporation's taxes on its other income; and

(*c*) Taxes of a first-tier corporation or a second-tier corporation shall not be deemed paid with respect to distributions from the earnings and profits of such corporation which are offset by a deficit allocated under paragraph (b)(2) of this section to the United States shareholder's proportionate share of the earnings and profits of such corporation; and

(ii) The foreign tax credit may be reduced and the reduction deferred under subparagraph (3) of this paragraph to another taxable year of the United States shareholder.

(2) *Nonaveraging of tax*—(i) *Year of minimum distribution*—(*a*) *Taxes deemed paid by a first-tier corporation and taxes actually paid by such corporation.* If, by successive distributions through a chain or group, a United States shareholder receives for a taxable year a distribution of the earnings and profits for such year of any corporation in such chain or group, and if both section 902(a) and section 902(b) apply with respect to such distribution, all the taxes deemed paid under section 902(b) by the first-tier corporation described in section 902(a) with respect to such distribution of such earnings and profits shall be deemed paid by the United States shareholder for such taxable year under section 902(a) with respect to the earnings and profits so distributed and, notwithstanding the rules otherwise applicable under section 902, no part of the taxes so deemed paid by such first-tier corporation shall be attributed to other earnings and profits of such first-tier corporation for such year and no part of the taxes paid or accrued with respect to such other earnings and profits shall be attributed to the earnings and profits so received as a distribution.

(*b*) *Taxes of a foreign corporation paid on intercorporate distributions and on other income.* If, by successive distributions through a chain or group, a United States shareholder receives for a taxable year a distribution of the earnings and profits for such year of any corporation in such chain or group, then in applying section 902(a) with respect to such distribution through a first-tier corporation described in section 902(a), or in applying section 902(b) with respect to such distribution through a second-tier corporation described in section 902(b), as the case may be, the taxes of such corporation which shall be taken into account in determining taxes deemed paid under such section shall be the foreign income tax actually paid or accrued for the taxable year by such first-tier or second-tier corporation, as the case may be, with respect to such distribution; and, notwithstanding the rules otherwise applicable under section 902, no part of the taxes so paid by such first-tier or second-tier corporation shall be attributed to other earnings and profits of such corporation for such year and no part of the taxes paid or accrued with respect to such other earnings and profits shall be attributed to the earnings and profits so received as a distribution.

(*c*) *Corporation with earnings and profits reduced by allocated deficits.* In the application of section 902, a United States shareholder's proportionate share of the earnings and profits for the taxable year of a foreign corporation to which the chain or group election applies shall reflect the reduction of such earnings and profits by deficits allocated thereto under paragraph (b)(2) of this section. No taxes paid or accrued by such corporation shall be deemed paid under section 902 with respect to a distribution to such shareholder from the earnings and profits of such corporation for such year to the extent that such distribution exceeds the shareholder's proportionate share as so reduced.

(ii) *Year of distribution of remaining earnings and profits.* If for a taxable year in respect of which a United States shareholder receives a minimum distribution pursuant to an election under section 963 and in respect of which the provisions of this subparagraph are applied—

(*a*) The foreign income tax which is paid or accrued by a foreign corporation for such year, by reason of the receipt and payment of earnings and profits counting toward such minimum distribution, is deemed paid under subdivision (i) (*a*) or (*b*) of this subparagraph,

(*b*) The pretax and predistribution earnings and profits for such year of a foreign corporation in a chain or group with respect to stock on which such minimum distribution is received are reduced by reason of the deduction under paragraph (d)(1)(i) of § 1.963-2 of distributions received from other corporations in such chain or group, or

(*c*) Such shareholder's proportionate share of the earnings and profits for such year of a foreign corporation in a chain or group making a distribution counting toward such minimum distribution is reduced by the allocation thereto under paragraph (b)(2) of this section of a portion of the deficits of foreign branches or other foreign corporations in such chain or group,

the pretax and predistribution earnings and profits of such foreign corporation for such year to which such minimum distribution is attributable and the foreign income tax which is taken into account in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder. For the purpose of applying the preceding sentence to a case in which (*c*) of this subdivision applies, the pretax and predistribution earnings and profits of the foreign corporation for such year to which the minimum distributed is attributable shall be the amount of such corporation's earnings and profits which are distributed and count toward the minimum distribution plus the foreign income tax of such foreign corporation allocated thereto in determining the taxes deemed paid under section 902 for the taxable year of the minimum distribution.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example (*1*). Domestic corporation M makes a chain election for 1966 with respect to controlled foreign corporation A, which is wholly owned directly by M Corporation, and controlled foreign corporation B, which is wholly owned directly by A Corporation. Each corporation uses the calendar year as the taxable year. In 1966, corporations A and B are subject to foreign income tax at the rates of 20 percent and 30 percent, respectively, with no deduction being allowed for dividends received or paid; each such corporation has pretax and predistribution earnings and profits of $100. Corporation M receives from the chain a pro rata minimum distribution for such year and applies thereto the special rules of this paragraph and paragraph (b) of this section. Corporation A is not a less developed country corporation under section 902(d). The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows:

	A	B	Total
Pretax and predistribution earnings and profits	$100.00	$100.00	$200.00
Foreign income tax	20.00	30.00	50.00
Consolidated earnings and profits	80.00	70.00	150.00
Effective foreign tax rate ($50/[$150 + $50])			25%
Statutory percentage under section 963(b)			76%
Amount distributed as pro rata minimum distribution for 1966:			
(0.76 × $80)	60.80		
(0.76 × $70)		53.20	114.00
Amount received by M Corporation as pro rata minimum distribution:			
A Corporation's distribution	$60.80		
B Corporation's distribution ($53.20 − [0.20 × $53.20]), or ($53.20 − $10.64)		$42.56	$103.36
Amount of tax counted toward minimum distribution			10.64
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under sec. 78 and foreign tax credit:			
($60.80/$80 × $20)	15.20		
([$42.56/$42.56 × $10.64] + [$53.20/$70 × $30]) or ($10.64 + $22.80)		33.44	48.64
Remaining 1966 earnings and profits for future distribution to M Corporation:			
($80 − $60.80)	19.20		
($70 − $53.20)		16.80	36.00
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:			
($19.20/$80 × $20)	4.80		
($16.80/$70 × $30)		7.20	12.00

Example (*2*). The facts are the same as in example (1) except that A Corporation pays foreign income tax at the rate of 30 percent and B Corporation, at the rate of 20 percent; and A Corporation is allowed a deduction, in computing its income subject to tax, for the full amount of dividends received. The determination of tax deemed paid for 1966 is as follows:

	A	B	Total
Pretax and predistribution earnings and profits	$100.00	$100.00	$200.00
Foreign income tax	30.00	20.00	50.00
Consolidated earnings and profits	70.00	80.00	50.00
Effective foreign tax rate ($50/[$150 + $50])			25%
Statutory percentage under section 963(b)			76%
Amount distributed by foreign corporations as a pro rata minimum distribution for 1966 and amount received by M Corporation:			
(0.76 × $70)	$53.20		
(0.76 × $80)		$60.80	$114.00
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under sec. 78 and foreign tax credit:			
($53.20/$70 × $30)	22.80		
($60.80/$80 × $20)		15.20	38.00
Remaining 1966 earnings and profits for future distribution to M Corporation:			
($70 − $53.20)	16.80		
($80 − $60.80)		19.20	36.00
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:			
($16.80/$70 × $30)	7.20		
($19.20/$80 × $20)		4.80	12.00

Example (*3*). For 1966, domestic corporation M makes a group election with respect to controlled foreign corporations A and B, both of which are wholly owned directly by M Corporation, and foreign branch C of M Corporation. All such corporations use the calendar year as the taxable year. Corporation M receives a pro rata minimum distribution from the group for 1966 and applies thereto the special rules of this paragraph and paragraph (b) of this section. Neither foreign corporation is a less developed country corporation under section 902(d). Corporations A and B pay foreign income tax at a flat rate of 20 percent and 30 percent, respectively. The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows:

	A	B	Branch C	Total
Pretax and predistribution earnings and profits (and deficit) of the group	$60.00	$60.00	($20)	$100.00
Foreign income tax	12.00	18.00		30.00

	A	B	Branch C	Total
Earnings and profits (and deficit)	48.00	42.00	(20)	70.00
Allocation of deficit of Branch C:				
($48/[$48+$42]×$20)	(10.67)			
($42/[$48+$42]×$20)		(9.33)		
Consolidated earnings and profits of the group	37.33	32.67		70.00
Effective foreign tax rate ($30/$100)				30%
Statutory percentage under sec. 963(b)				69%
Amount received by M Corporation as pro rata minimum distribution for 1966:				
(0.69×$37.33)	25.76			
(0.69×$32.67)		22.54		$48.30
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under sec. 78 and foreign tax credit:				
($25.76/$37.33×$12)	8.28			
($22.54/$32.67×$18)		12.42		20.70
Remaining 1966 earnings and profits for future distribution to M Corporation:				
($48−$25.76)	22.24			
($42−$22.54)		19.46		41.70
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:				
($12−$8.28)	3.72			
($18−$12.42)		5.58		9.30

Example (*4*). The facts are the same as in example (3) except that the group does not make a pro rata minimum distribution but distributes $48.30, consisting of $40 distributed by A Corporation and $8.30 distributed by B Corporation. Corporation M complies with the special rules of this paragraph and paragraph (b) of this section. The 1966 foreign income tax of corporations A and B which is deemed paid by M Corporation under section 902(a) for 1966, and the remaining tax which is allocated to earnings and profits to be distributed to M Corporation in future years, are determined as follows, the minimum overall tax burden for 1966 being such as to satisfy the requirement of paragraph (a)(1)(ii)(*b*) of this section:

	A	B	Branch C	Total
Amount received by M Corporation	$40.00	$8.30		$48.30
Tax deemed paid by M Corporation for 1966 for purposes of gross-up under sec. 78 and foreign tax credit:				
($37.33/$37.33×$12)	12.00			
($8.30/$32.67×$18)		4.57		16.57
Remaining 1966 earnings and profits for future distribution to M Corporation:				
($48−$40)	8.00			
($42−$8.30)		33.70		41.70
Foreign income tax attributable to 1966 earnings and profits remaining for future distribution to M Corporation:				
($12−$12)	0			
($18−$4.57)		13.43		13.43

(3) *Reduction and deferral of the foreign tax credit*—(1) *In general.* To the extent specified in paragraph (a)(1)(ii)(*b*) of this section a reduction shall be made in the foreign tax credit allowable under section 901 for the taxable year with respect to distributions counting toward a minimum distribution for such year from the chain or group; and such reduction in credit shall be allocated, as provided in subdivision (ii) of this subparagraph, to foreign corporations in such chain or group and deferred, as provided in subdivision (iii) of this subparagraph, to subsequent taxable years of the United States shareholder.

(ii) *Allocation of reduction in foreign tax credit.* The amount of any reduction in foreign tax credit for the taxable year which is made under subdivision (i) of this subparagraph with respect to a minimum distribution for any taxable year from the chain or group shall be allocated among any first-tier and second-tier corporations described in section 902 (a) and (b), respectively, which are in such chain or group. The amount of any such reduction in foreign tax credit shall be allocated among such first-tier and second-tier corporations in the ratio which the United States shareholder's proportionate share of undistributed earnings and profits of each such corporation for the taxable year bears to the total of such shareholder's proportionate shares of the undistributed earnings and profits of all such corporations for such year. None of such reduction shall be allocated to any other corporations in the chain or group or to any foreign branches included under paragraph (f)(4) of § 1.963-1 in the group as wholly owned foreign subsidiary corporations.

(iii) *Deferral of allocated credit—(a) Allowance of credit in subsequent years.* The reduction in foreign tax credit allocated to a first-tier or second-tier corporation in the chain or group for a taxable year under subdivision (ii) of this subparagraph shall be deemed paid under the principles of section 902 (applicable to foreign corporations which are not less developed country corporations) with respect to distributions, to the extent made by such corporation to the United States shareholder referred to in subdivision (ii) of this subparagraph, in a subsequent taxable year from the undistributed earnings and profits of such corporation for such year of allocation. Thus, for example, in the case of a distribution in the subsequent year from such earnings and profits by a first-tier corporation, the tax deemed paid shall be an amount which bears to the total of such reduction in foreign tax credit the same ratio that the distribution to the shareholder in the subsequent year bears to such shareholder's proportionate share of such undistributed earnings and profits for the year of allocation.

(b) Limitations on use of deferred credit. The deferred tax so deemed paid shall be deemed paid for such subsequent taxable year and shall be allowed under section 901 (without regard to the limitations under section 904) as a credit against the income tax imposed for such year by chapter 1 of the Code, but the amount of such credit shall not exceed the excess of the tax so imposed for such year over the credit (determined without regard to this subdivision (iii) allowed under sections 901 through 905 for such year. Any amount by which the deferred tax so deemed paid in such subsequent taxable year exceeds the limitation under the preceding sentence shall not be carried back or carried over under section 904(d) to another taxable year of the United States shareholder. No credit shall be allowed under this subdivision for the subsequent taxable year to the extent that the credit would reduce the tax of the United States shareholder under chapter 1 of the Code on any minimum distribution for such year to which section 963 applies.

(c) Gross-up not applicable. Any amount allowed as a credit for a subsequent taxable year under this subdivision shall not be included in the gross income of the United States shareholder for such year under section 78.

(d) Illustrations. The application of this section may be illustrated by the following examples, in which the surtax exemption provided by section 11(c) is disregarded:

Example (1). (a) For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, which it wholly owns directly, and controlled foreign corporation B, which A Corporation wholly owns directly. Corporation A is not a less developed country corporation under section 902(d). All corporations use the calendar year as the taxable year. For 1966, M Corporation complies with the special rules of paragraphs (b) and (c) of this section. Corporation A has pretax and predistribution earnings and profits for 1966 of $40 and is subject to foreign income tax at a flat rate of 36 percent, with no deduction being allowed for dividends received or paid. B Corporation has pretax and predistribution earnings and profits of $60 for 1966 and is subject to a foreign income tax at a flat rate of 20 percent, with no deduction being allowed for dividends received or paid. For 1967, B Corporation has no earnings and profits, A Corporation has no earnings and profits other than a dividend of $21.22 from B Corporation, and M Corporation has taxable income of $20.98 from United States sources. Corporation M uses the overall limitation under section 904(a)(2) on the foreign tax credit.

(b) If a pro rata minimum distribution were made for 1966, the overall United States and foreign income tax for such year with respect to such distribution would be $41.30, determined as follows:

	A	B	Total
Pretax and predistribution earnings and profits	$40.00	$60.00	$100.00
Foreign income tax:			
(0.36×$40)	14.40		
(0.20×$60)		12.00	26.40
Consolidated earnings and profits	25.60	48.00	73.60
Effective foreign tax rate ($26.40/[$73.60+$26.40])			26.4%
Statutory percentage under sec. 963(b)			69%
Amount distributed as pro rata minimum distribution:			
(0.69×$25.60)	17.66		
(0.69×$48)		33.12	$50.78
Amount received by M Corporation as pro rata minimum distribution:			
Corporation's distribution	17.66		
B Corporation's distribution ($33.12−[0.36× $33.12]), or ($33.12−$11.92)		21.20	38.86
Gross-up under sec. 78:			
($17.66/$25.60×$14.40)	9.94		
($21.20/$21.20×[$11.92+($33.12/$48×$12)], or ($11.92+$8.28)		20.20	30.14
Taxable income of M Corporation			69.00
U.S. tax before foreign tax credit ($69×0.48)			33.12
Foreign tax credit (as determined under gross-up above)			30.14
U.S. tax payable			2.98
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($26.40+$11.92+$2.98)			41.30

(c) The chain, however, does not make a pro rata distribution for 1966, but distributes $24 from A Corporation's earnings and profits and $26.78 from B Corporation's earnings and profits, the total distribution of $50.78 being equal to the statutory percentage of the consolidated earnings and profits (0.69×$73.60) of the chain with respect to M Corporation. Thus, M Corporation must make such a reduction in its foreign tax credit that the overall United States and foreign income tax for 1966 with respect to the distribution equals the lesser of $41.30 (the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution) and $43.20 (90 percent of 48 percent of pretax and predistribution consolidated earnings and profits of $100). The remaining 1956 earnings and profits of the chain are distributed late in 1967. Corporation M determines its tax as follows for such years:

1966

	A	B	Total
Distributions made	$24.00	$26.78	$50.78
Amount received by M Corporation:			
A Corporation's distribution	24.00		
B Corporation's distribution ($26.78−[0.36×26.78]), or ($26.78−$9.64)		17.14	41.14
Gross-up under sec. 78:			
($24/$25.60×$14.40)	13.50		
($17.14/$17.14×[$9.64+($26.78/$48×$12)), or ($9.64+$6.70)		16.34	29.84
Taxable income of M Corporation			$70.98
Tentative U.S. tax before foreign tax credit ($70.98×.48)			34.07
Less: Tentative foreign tax credit (as computed under gross-up above)			29.84
Tentative U.S. tax payable			4.23
Tentative overall U.S. and foreign income tax ($26.40+$9.64+$4.23)			40.27
Overall U.S. and foreign tax which would be paid with respect to a pro rata minimum distribution (par. (b) of this example)			41.30
Insufficient overall U.S. and foreign income tax ($41.30−$40.27)			1.03
Reduced foreign tax credit ($29.84−$1.03)			28.81
U.S. tax payable ($34.07−$28.81)			5.26
Overall U.S. and foreign income tax ($26.40+$9.64+$5.26)			41.30
Reduction in foreign tax credit to be deferred ($29.84−$28.81)			1.03
Remaining 1966 earnings and profits of:			
A Corporation ($25.60−$24)	$1.60		
B Corporation ($48−$26.78)		$21.22	22.82
Allocation of reduction in foreign tax credit to remaining 1966 earnings and profits of:			
A Corporation ($1.60/22.82×$1.03)	.07		
B Corporation ($21.22/$22.82×$1.03)		.96	1.03
Foreign income tax attributable to remaining 1966 earnings and profits of:			
A Corporation ($1.60/$25.60×$14.40)	.90		
B Corporation ($21.22/$48×$12)		5.30	6.20

1967

Taxable income of M Corporation consisting of distributions from:			
A Corporation's remaining 1966 earnings and profits	1.60		

1967

	A	B	Total
B Corporation's remaining 1966 earnings and profits ($21.22 – [.36 × 21.22]), or ($21.22 – $7.64)		13.58	15.18
Gross-up under sec. 78:			
($1.60/$1.60 × $0.90)	.90		
($13.58/$13.58 × [$7.64 + ($21.22/21.22 × $5.30)])		12.94	13.84
Taxable income from sources without the U.S.			29.02
Taxable income from sources within the U.S.			20.98
Total taxable income of M Corporation			50.00
U.S. tax before foreign tax credit (0.48 × $50)			24.00
Foreign tax credit:			
Tax deemed paid under sec. 902:			
$13.84, but not to exceed sec. 904 limitation of $13.93 ($29.02/$50 × $24) (see gross-up above)			13.84
Tax deemed paid under the principles of section 902:			
($1.60/$1.60 × $0.07)	.07		
($21.22/$21.22 × 0.96)		.96	1.03
U.S. tax payable ($24 – [$13.84 + $1.03])			9.13

Example (2). (a) For 1963, domestic corporation M makes a group election with respect to controlled foreign corporations A and B, both of which M Corporation wholly owns directly. All such corporations use the calendar year as the taxable year. Corporation A is created under the laws of foreign country X, and B Corporation is created under the laws of foreign country Y; neither of such corporations is a less developed country corporation under section 902(d). Corporation M complies with the special rules of paragraphs (b) and (c) of this section. Each foreign corporation has pretax earnings and profits of $100 for 1963. The income of A Corporation is subject to a foreign income tax rate of 20 percent, and the income of B Corporation is subject to a foreign income tax rate of 30 percent. Corporation M uses the per-country limitation under section 904(a)(1) on the foreign tax credit.

(b) If a pro rata minimum distribution were made for 1963, the group would distribute $123 based upon an effective foreign tax rate of 25 percent ($50/[$50 + $150]) and a statutory percentage of 82 percent under section 963(b); of this amount $57.40 (0.82 × $70) would be distributed from B Corporation's earnings and profits and $65.60 (0.82 × $80) would be distributed from A Corporation's earnings and profits. In such case, the overall United States and foreign income tax for 1963 with respect to the pro rata minimum distribution would be determined as follows, using the 52 percent United States corporate income tax rate applicable for such year:

Taxable income of M Corporation from sources in—		
Y Country:		
B Corporation dividend	$57.40	
Gross-up under sec. 78 ($57.40/$70 × $30)	24.60	$82.00
X Country:		
A Corporation dividend	65.60	
Gross-up under sec. 78 ($65.60/$80 × $20)	16.40	82.00
Taxable income		164.00
U.S. tax before tax credit (0.52 × $164)		85.28
Foreign tax credit:		
Y Country tax	24.60	
X Country tax	16.40	41.00
U.S. tax payable		44.28
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($44.28 + $50)		94.28

(c) The group, however, does not make a pro rata minimum distribution for 1963 but distributes $123, consisting of $70 from B Corporation's earnings and profits and $53 from A Corporation's earnings and profits. Thus, M Corporation must make such a reduction in its foreign tax credit that the overall United States and foreign income tax for 1963 with respect to the distribution equals the lesser of $94.28 (the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution) and $93.60 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $200). The remaining 1963 earnings and profits of the group are distributed late in 1964. Neither A Corporation nor B Corporation has earnings and profits for 1964. Corporation M determines its tax as follows for such years, assuming a 52 percent (instead of 50 percent) United States corporate income tax rate for 1964:

1963

Taxable income of M Corporation from sources in—		
Y Country:		
B Corporation dividend	$70.00	
Gross-up under sec. 78 ($70/$70 × $30)	30.00	$100.00
X Country:		
A Corporation dividend	53.00	
Gross-up under sec. 78 ($53/$80 × $20)	13.25	66.25
Taxable income for 1963		166.25

1963—Continued

U.S. tax before foreign tax credit (0.52×$166.25)		86.45
Less: Tentative foreign tax credit:		
Y Country tax ($30.00 but not to exceed ($100.00/$166.25×$86.45))	30.00	....
X Country tax ($13.25 but not to exceed ($66.25/$166.25×$86.45))	13.24	43.25
Tentative U.S. tax payable		43.20

Tentative overall U.S. and foreign income tax ($50+$43.20)		93.60
Insufficient overall U.S. and foreign income tax ($93.60−$93.20)		.40
Reduced foreign tax credit ($43.25−$0.40)		42.85
U.S. tax payable for 1963 ($86.45−$42.85)		43.00
Overall U.S. and foreign income tax ($50+$43.60)		93.60
Reduction in foreign tax credit to be deferred ($43.25−$42.85)		.40
Remaining 1963 earnings and profits of:		
A Corporation ($80−$53)	27.00	....
B Corporation ($70−$70)	0	27.00
Allocation of reduction in foreign tax credit to remaining 1963 earnings and profits of A Corporation ($27/$27×$0.40)		.40
Foreign income tax attributable to remaining 1963 earnings and profits of:		
A Corporation ($20−$13.25)	6.75	....
B Corporation ($30−$30)	0	6.75

1964

Taxable income of M Corporation from sources in X Country:		
A Corporation dividend		27.00
Gross-up under sec. 78 ($27/$27×$6.75)		6.75
Taxable income for 1964		33.75

U.S. tax before foreign tax credit ($33.75×0.52)		17.55
Less: Foreign tax credit:		
Tax deemed paid under sec. 902 (as computed under gross-up, but not to exceed $33.75/$33.75×$17.55)	6.75	....
Tax deemed paid under the principles of sec. 902 ($27/$27×$0.40)	.40	7.15
U.S. tax payable for 1964		10.40

Example (3). (a) For 1966, domestic corporation M makes a chain election with respect to controlled foreign corporation A, which it wholly owns directly, and controlled foreign corporation B, which A Corporation wholly owns directly. Corporation A is a less developed country corporation under section 902(d). All corporations use the calendar year as the taxable year. For 1966, each of the foreign corporations has pretax and predistribution earnings and profits of $100. The income of A Corporation is subject to a foreign income tax rate of 20 percent, with no deduction being allowed for dividends received or paid; and the income of B Corporation is subject to a foreign income tax rate of 30 percent on such basis. During 1966, B Corporation distributes $50 to A Corporation, and A Corporation distributes $104 to M Corporation. During 1967 the remaining 1966 earnings and profits of such corporations are distributed to M Corporation.

(b) If M Corporation were not to comply with the special rules of paragraphs (b) and (c) of this section and were to deduct foreign income tax on intercorporate distributions under paragraph (d)(1)(iii) of § 1.963-2, the chain would not be considered to make a minimum distribution for 1966 because, although it makes a distribution which is sufficient in amount to constitute a minimum distribution, the overall United States and foreign income tax for such year with respect to such distribution would be insufficient under paragraph (a)(1)(i) of this section. The determination that M Corporation would not be entitled to the section 963 exclusion for 1966 by reason of such distribution in such circumstances is made as follows:

	A	B	Total
Pretax earnings and profits	$150	$100	....
Reduction for intercorporate dividends	50	....	....
Pretax and predistribution earnings and profits	100	100	$200.00
Reduction for foreign income tax on such pretax and predistribution earnings and profits	20	30	50.00
Predistribution earnings and profits	80	70	150.00
Reduction for foreign income tax on intercorporate distributions of 1966 earnings and profits ($50×0.20)	10	....	10.00
Consolidated earnings and profits of the chain	70	70	140.00
Consolidated foreign income taxes ($30+$20+$10)	....	....	60.00
Effective foreign tax rate ($60/[$140+$60])	....	....	30%
Statutory percentage under sec. 963(b)	....	....	69%
Amount of a minimum distribution ($140×0.69)	....	....	96.60
Overall United States and foreign income tax required to be paid (par. (a)(1)(i) of this sec.) (0.90×[0.22+0.26]×$200)	....	....	86.40
Tentative taxable income of M Corporation	....	....	104.00
Tentative U.S. tax before foreign tax credit (0.48×$104)	....	....	49.92

	A	B	Total
Tentative foreign tax credit ($104/$120 × [($120/$150 × $30) + ($50/$100 × $30)] or ($104/$120 × $39)			$33.80
Tentative U.S. tax payable ($49.92 − $33.80)			16.12
Overall U.S. and foreign income tax ($60 + $16.12)			76.12
Insufficient overall U.S. and foreign income tax ($86.40 − $76.12)			10.28

(c) By complying with the special rules of paragraphs (b) and (c) of this section, however, M Corporation will receive a minimum distribution for 1966 if it receives the statutory percentage of consolidated earnings and profits and if the overall United States and foreign income tax with respect to the distribution which is made is at least the lesser of $86.40 (0.90 × 0.48 × $200) and of the overall United States and foreign income tax which would be paid with respect to a pro rata minimum distribution from the chain. If a pro rata minimum distribution were made for 1966, the chain would be required to distribute earnings and profits of $114, based upon an effective foreign tax rate of 25 percent ($50/[$50 + $150]) and a statutory percentage of 76 percent under section 963(b); of this amount $53.20 (0.76 × $70) would be distributed from B Corporation's earnings and profits and $60.80 (0.76 × $80) would be distributed from A Corporation's earnings and profits. The overall United States and foreign income tax with respect to such a pro rata minimum distribution would be $73.62, determined as follows:

Taxable income of M Corporation ($60.80 + [$53.20 − ($53.20 × 0.20)])		$103.36
U.S. tax before foreign tax credit (0.48 × $103.36)		49.61
Foreign tax credit:		
B Corporation's distribution ($53.20/[$70 + $30] × $30) + ($42.56 + $10.64] × $10.64)	$24.47	
A Corporation's distribution ($60.80/[$80 + 20] × $20)	12.16	36.63
U.S. tax payable		12.98
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($50 + $10.64 + $12.98)		73.62

(d) The United States income tax of M Corporation for 1966 and 1967 is determined as follows, assuming that the minimum overall tax burden is determined under paragraph (a)(1)(ii)(b) of this section:

1966

Dividend from earnings and profits of—		
B Corporation ($50 minus tax of $10 on A Corporation at the rate of 20 percent)		$40.00
A Corporation		64.00
Taxable income of M Corporation		104.00
U.S. tax before foreign tax credit (0.48 × $104)		$49.92
Less: Foreign tax credit:		
B Corporation's distribution ($50/[$70 + $30] × $30 + ($40/[$40 + $10] × $10), or ($15 + $8)	$23.00	
A Corporation's distribution ($64/$80 + $20] × $20)	12.80	35.80
U.S. tax payable		$14.12
Overall U.S. and foreign income tax with respect to actual distribution ($50 + $10 + $14.12)		74.12
Overall U.S. and foreign income tax that would be paid with respect to a pro rata minimum distribution (par. (c) of this example)		73.62
Remaining 1966 earnings and profits for future distribution by:		
B Corporation ($70 − $50)		20.00
A Corporation ($80 − $64)		16.00
Total		36.00
Foreign income tax attributable to remaining 1966 earnings and profits of:		
B Corporation ($20/$70 × $30)		8.57
A Corporation ($16/$80 × $20)		4.00

1967

Dividend from remaining 1966 earnings and profits of—		
B Corporation ($20 minus tax of $4 on A Corporation at the rate of 20 percent)		16.00
A Corporation		16.00
Taxable income of M Corporation		32.00
U.S. tax before foreign tax credit (0.48 × $32)		15.36
Less: Foreign tax credit:		
B Corporation's distribution ($20/[$20 + $8.57] × $8.57) + ($16/[$16 + $4] × $4), or ($6 + $3.20)	$9.20	
A Corporation's distribution ($16/[$16 + $4] × $4)	3.20	12.40
U.S. tax payable		2.96

Example (4). (a) Domestic corporation M directly owns 90 percent of the one class of stock of controlled foreign corporation A, which directly owns 80 percent of the one class of stock of controlled foreign corporation B, which in turn directly owns 60 percent of the one class of stock of controlled foreign corporation C. None of the foreign corporations are less developed country corporations under section 902(d); all corporations use the calendar year as the taxable year. For 1963, M Corporation makes a chain election with respect to corporations A, B, and C and receives a distribution from the consolidated earnings and profits of the chain which does not constitute a pro rata minimum distribution. The remaining 1963 consolidated earnings and profits of the chain are distributed late in 1964, for which year it is assumed that the United States corporate income tax rate is the same (52 percent) as for 1963. No corporation in the chain has earnings and profits for 1964 other than from distributions received from remaining 1963 earnings and profits of another corporation in the chain. The foreign country under the laws of which A Corporation is created does not tax dividends which are received by such corporation from B Corporation, but B Corporation is taxed on dividends received from C Corporation. Corporation M complies with the special rules of paragraphs (b) and (c) of this section and determines the minimum overall tax burden under paragraph (a)(1)(ii)(b) of this section with respect to the distribution which is made. Corporation M uses the overall limitation under section 904(a)(2) on the foreign tax credit. The distribution received by M Corporation for 1963 from the consolidated earnings and profits of the chain is sufficient in amount to constitute a minimum distribution. The overall United States and foreign income tax for 1963 with respect to the distribution which is made must be at least equal to the lesser of $32.21 (the amount payable, as determined under paragraph (b) of this example, with respect to a pro rata minimum distribution) and $31.34 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $66.96).

(b) If the chain were to make a pro rata minimum distribution, the distributions and the overall United States and foreign income tax for 1963 with respect to the minimum distribution would be determined as follows, based upon the facts assumed:

	A	B	C	Total
Pretax and predistribution earnings and profits	$20.00	$50.00	$30.00	
Reduction for foreign income tax on such earnings and profits (10%, 40%, and 10%, respectively)	2.00	20.00	3.00	
Predistribution earnings and profits	18.00	30.00	27.00	
Consolidated earnings and profits with respect to M Corporation:				
(0.90 × $18)	16.20			
(0.90 × 0.80 × $30) or (0.72 × $30)		21.60		
(0.90 × 0.80 × 0.60 × $27) or (0.432 × $27)			11.66	$49.46
Consolidated foreign income taxes with respect to M Corporation:				
($16.20/$18 × $2)	1.80			
($21.60/$30 × $20)		14.40		
($11.66/$27 × $3)			1.30	17.50
Effective foreign tax rate of the chain for 1963 ($17.50/[$49.46 + $17.50]), or ($17.50/ $66.96)				26.14%
Statutory percentage under sec. 963(b)				82%
Pro rata minimum distribution (before reduction of dividend from C Corporation's share by B Corporation tax paid on such amount):				
(0.82 × $16.20)	13.28			
(0.82 × $21.60)		17.71		
(0.82 × $11.66)			9.56	
(0.82 × $49.46)				40.56
Such amounts as reduced by further foreign income tax imposed on distributions through the chain:				
No further foreign tax	13.28			
No further foreign tax		17.71		
B Corporation tax ($9.56 – [0.40 × $9.56]), or ($9.56 – $3.82)			5.74	36.73
Gross-up under sec. 78:				
($13.28/$16.20 × $1.80)	1.48			
($17.71/$21.60 × $14.40)		11.81		
($5.74/$5.74 × $3.82)		3.82		17.11
M Corporation's taxable income for 1963 attributable to minimum distribution ($36.73 + $17.11)				53.84
U.S. tax before foreign tax credit ($53.84 × 0.52)				28.00
Foreign tax credit (as determined under gross-up above)				17.11
U.S. tax payable for 1963 ($28 – $17.11)				10.89
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($17.50 + $3.82 + $10.89)				32.21

(c) Based upon the distributions which are made by corporations A, B, and C, M. Corporation pays United States tax as follows for 1963 and 1964:

1963

	A	B	C	Total
Distribution made from consolidated earnings and profits of the chain	$9.36	$21.60	$9.60	$40.56
Excess of distribution over statutory percentage of consolidated earnings and profits for 1963 ($40.56 − [0.82 × $49.46])				None
Determination of whether the overall U.S. and foreign income tax with respect to the actual distribution is equal to, or exceeds, the lesser of $32.21 (paragraph (b) of example) and $31.34 (paragraph (a) of example):				
Amount received by M Corporation after reduction by further foreign income tax imposed on distributions through the chain:				
No further foreign tax	9.36			
No further foreign tax		21.60		
B Corporation tax ($9.60 − [0.40 × $9.60]), or ($9.60 − $3.84)			5.76	36.72
Gross-up under sec. 78:				
($9.36/$16.20 × $1.80)	1.04			
($21.60/$21.60 × $14.40)		14.40		
($5.76/$5.76 × $3.84)		3.84		19.28
Taxable income of M Corporation for 1963 attributable to actual distribution ($36.72 + $19.28)				56.00
U.S. tax before foreign tax credit ($56 × 0.52)				29.12
Tentative foreign tax credit (as determined under gross-up above)				19.28
Tentative U.S. tax payable ($29.12 − $19.28)				9.84
Overall U.S. and foreign income tax with respect to actual distribution ($17.50 + $3.84 + $9.84)				31.18
Insufficient overall U.S. and foreign income tax ($31.34 [i.e., 0.90 × 0.52 × $66.96] − 31.18)				.16
Reduced foreign tax credit ($19.28 − $0.16)				19.12
U.S. tax payable for 1963 ($29.12 − $19.12)				10.00
Overall U.S. and foreign income tax with respect to actual distribution ($17.50 + $3.84 + $10)				31.34
Allocation of reduction in foreign tax credit to undistributed consolidated 1963 earnings and profits of A and B Corporations to be deemed paid by M Corporation in future years:				
Reduction in foreign tax credit ($19.28 − $19.12)				.16
Undistributed 1963 consolidated earnings and profits of the chain:				
($16.20 − $9.36)	6.84			
($21.60 − $21.00)		0		
($11.66 − $9.60)			$2.06	8.90
Allocation of reduction in credit:				
($6.84/$6.84 × $0.16)	.16			.16
Foreign income tax attributable to undistributed 1963 earnings and profits of the chain to be taken into account in determining tax deemed paid under sec. 902:				
($1.80 − $1.04)	.76			
($14.40 − $14.40)				.7

1964

Distribution from remaining 1963 consolidated earnings and profits of the chain:				
($16.20 − $9.36)	6.84			
($21.60 − $21.60)		0		
($11.66 − $9.60)			2.06	8.90
Such amounts as reduced by further foreign income tax imposed on distributions through the chain:				
No further foreign tax	6.84			
B Corporation tax ($2.06 − [0.40 × $2.06]), or ($2.06 − $0.82)		1.24		8.08
Gross-up under sec. 78:				
($6.84/$6.84 × $0.76)	0.76			
($1.24/$1.24 × $0.82)		0.82		1.58
Taxable income of M Corporation for 1964 attributable to 1964 distribution ($8.08 + $1.58)				9.66
U.S. tax before foreign tax credit ($9.66 × 0.52)				5.02
Foreign tax credit:				
Deferred credit in accordance with principles of sec. 902 ($6.84/$6.84 × $0.16)	0.16			0.16
Tax deemed paid under sec. 902 (computed under gross-up above)				1.58
U.S. tax payable for 1964 ($5.02 − [$0.16 + $1.58])				3.28

Example (5). (a) Domestic corporation M directly owns all the one class of stock of each of controlled foreign corporations A, B, C, and D. All such corporations use the calendar year as the taxable year. None of the foreign corporations is a less developed country corporation under section 902(d). For 1963, M Corporation makes a group election with respect to corporations A, B, C, and D and receives from the 1963 consolidated earnings and profits of the group a distribution which is not a pro rata minimum distribution. None of the foreign corporations has earnings and profits for 1964, but the remaining 1963 earnings and profits of the group are distributed late in 1964, for which year it is assumed that the United States corporate income tax rate is the same (52 percent) as for 1963. The overall limitation under section 904(a)(2) on the foreign tax credit applies for both years.

(b) Assume that M Corporation does not comply with the special rules of paragraphs (b) and (c) of this section and that for 1963 it draws a distribution of all of B Corporation's earnings and profits and enough of C Corporation's earnings and profits to receive the amount of a minimum distribution and to assure that the overall United States and foreign income tax for such year with respect to the distribution from the group satisfies the overall minimum tax requirement of paragraph (a)(1)(i) of this section. In such case, the overall United States and foreign income tax for 1963 with respect to the distribution which is made, determined by using the foreign tax credit under section 901 without applying the special credit rules of paragraph (c) of this section, must at least equal $37.44 (90 percent of 52 percent of pretax and predistribution consolidated earnings and profits of $80). Corporation M's United States income tax for 1963 and 1964 with respect to the distribution of the 1963 earnings and profits of the group is determined as follows, based upon the facts assumed:

1963

	A	B	C	D	Total
Pretax and predistribution earnings and profits (and deficits) of the group	$25.00	$25.00	$50.00	($20.00)	$80.00
Consolidated foreign income taxes	2.50	12.50	15.00		30.00
Consolidated earnings and profits	22.50	12.50	35.00	(20.00)	50.00
Effective foreign tax rate ($30/[$50 + $30])					37.5%
Statutory percentage under sec. 963(b)					68%
Amount of a minimum distribution (0.68 × $50)					34.00
Tentative distribution		12.50	21.50		34.00
Tentative gross-up under sec. 78:					
($12.50/$12.50 × $12.50)		12.50			
($21.50/$35 × $15)			9.21		21.71
Tentative taxable income of M Corporation ($34 + $21.71)					55.71
Tentative U.S. tax before foreign tax credit (0.52 × $55.71)					28.97
Tentative foreign tax credit (as computed under gross-up above)					21.71
Tentative U.S. tax payable ($28.97 – $21.71)					7.26
Tentative overall U.S. and foreign income tax ($30 + $7.26)					37.26
Minimum overall U.S. and foreign income tax required to be paid (0.90 × .52 × $80)					37.44
Insufficient overall U.S. and foreign income tax ($37.44 – $37.26)					.18
Revised distribution		12.50	22.07		34.57
Gross-up under sec. 78:					
($12.50/$12.50 × $12.50)		12.50			
($22.07/$35 × $15)			9.46		21.96
Taxable income of M Corporation ($34.57 + $21.96)					56.53
U.S. tax before foreign tax credit (.52 × $56.53)					29.40
Foreign tax credit (as computed under gross-up above)					21.96
U.S. tax payable ($29.40 – $21.96)					7.44
Overall U.S. and foreign income tax on actual distribution ($30 + $7.44)					37.44

1964

Distribution of remaining 1963 consolidated earnings and profits:					
($22.50 – $0)	22.50				
($12.50 – $12.50)					
($35 – $22.07)			12.93		35.43
Gross-up under sec. 78:					
($22.50/$22.50 × $2.50)	2.50				
($12.93/$35 × $15)			5.54		8.04
Taxable income of M Corporation ($35.43 + $8.04)					43.47
U.S. tax before foreign tax credit ($43.47 × 0.52)					22.60
Foreign tax credit (as computed under gross-up above)					8.04
U.S. tax payable ($22.60 – $8.04)					14.56

(c) Assume that M Corporation does comply with the special rules of paragraphs (b) and (c) of this section and for 1963 receives a minimum distribution consisting of $20 from A Corporation and $14 from C Corporation. In such case, the overall United States and foreign income tax for 1963 with respect to the minimum distribution must at least equal the lesser of $37.44 (0.90 × 0.52 × $80) and the overall United States and foreign income tax of $37.89 that would be paid with respect to a pro rata minimum distribution from the group for such year. In such case, the determinations would be made pursuant to subparagraphs (1) and (2) of this paragraph.

(1) If a pro rata minimum distribution were made for 1963 by the group, the overall United States and foreign income tax for such year with respect to such distribution would be $37.89, determined as follows:

	A	B	C	D	Total
Pretax and predistribution earnings and profits (and deficits) of the group	$25.00	$25.00	$50.00	($20)	$80.00
Consolidated foreign income taxes	2.50	12.50	15.00		30.00
Consolidated earnings and profits before allocation of deficits	22.50	12.50	35.00		70.00
Allocation of deficit of D Corporation:					
($22.50/$70 × $20)	(6.43)				
($12.50/$70 × $20)		(3.57)			
($35/$70 × $20)			(10.00)		(20.00)
Consolidated earnings and profits	16.07	8.93	25.00		50.00
Effective foreign tax rate ($30/$80)					37.50%
Statutory percentage under section 963(b)					68%
Pro rata minimum distribution:					
(0.68 × $16.07)	10.93				
(0.68 × $8.93)		6.07			
(0.68 × $25)			17.00		34.00
Gross-up under sec. 78:					
($10.93/$16.07 × $2.50)	1.70				
($6.07/$8.93 × $12.50)		8.50			
($17/$25 × $15)			10.20		20.40
Taxable income of M Corporation ($34 + $20.40)					54.40
U.S. tax before foreign tax credit (0.52 × $54.40)					28.29
Foreign tax credit (as computed under the gross-up above)					20.40
U.S. tax payable ($28.29 – $20.40)					7.89
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($30 + $7.89)					37.89

(2) Corporation M's United States income tax for 1963 and 1964 with respect to the distribution of the 1963 earnings and profits of the group is determined as follows:

1963

	A	B	C	D	Total
Distributions actually made	$20.00		$14.00		$34.00
Gross-up under sec. 78:					
($16.07/$16.07 × $2.50)	2.50				
($14/$25 × $15)			8.40		10.90
Taxable income of M Corporation ($34 + $10.90)					44.90
U.S. tax before foreign tax credit (0.52 × $44.90)					23.35
Foreign tax credit (as computed under gross-up above)					10.90
U.S. tax payable ($23.35 – $10.90)					12.45
Overall U.S. and foreign income tax with respect to the distribution actually made ($30 + $12.45), such amount being in excess of the minimum overall tax burden of $37.44					42.45

1964

Earnings and profits for 1963 to which minimum distribution for such year was not attributable:					
($22.50 – $20)	2.50				
($12.50 – $0)		12.50			
($35.00 – $14)			21.00		36.00

1964—Continued

	A	B	C	D	Total
Foreign income tax for 1963 not taken into account in determining tax deemed paid for such year on pretax earnings and profits to which the minimum distribution for such year was attributable:					
([$16.07 – $16.07]/$16.07 × $2.50)	0				
([$8.93 – $0]/$8.93 × $12.50)		12.50			
([$25 – $14]/$25 × $15)			6.60		19.10
Distributions to M Corporation in 1964	2.50	12.50	21.00		36.00
Gross-up under sec. 78:					
($2.50/$2.50 × $0)	0				
($12.50/$12.50 × $12.50)		12.50			
($21/$21 × $6.60)			6.60		19.10
Taxable income of M Corporation ($36 + $19.10)					55.10
U.S. tax before foreign tax credit (0.52 × $55.10)					28.65
Foreign tax credit (as computed under gross-up above)					19.10
U.S. tax payable ($28.65 – $19.10)					9.55

Example (6). Throughout 1963, domestic corporation M directly owns all the one class of stock of controlled foreign corporations A, B, and C, and maintains in a foreign country a branch which qualifies under paragraph (f)(4) of § 1.963-1 for inclusion in a group as a wholly owned foreign subsidiary corporation. For 1963, a year for which the overall limitation under section 904(a)(2) on the foreign tax credit applies, M Corporation makes a group election with respect to A, B, and C Corporations and the foreign branch. All such corporations use the calendar year as the taxable year. The foreign branch has pretax and predistribution earnings and profits of $40 for 1963, as determined under paragraph (f)(4)(ii) of § 1.963-1. None of the foreign corporations is a less developed country corporation under section 902(d). Corporation M complies with the special rules of paragraphs (b) and (c) of this section. The United States income tax of M Corporation for 1963 is as follows, based upon the facts assumed:

	Branch	C	D	Total	
Pretax and predistribution consolidated earnings and profits of the group	$20.00	$30.00	$10	$40	$100.00
Consolidated income taxes	2.00	15.00	5	20	42.00
Effective foreign tax rate ($42/$100)					42%
Statutory percentage under sec. 963(b)					40%
Posttax and predistribution consolidated earnings and profits of the group	18.00	15.00	5	20	58.00
U.S. tax which would be paid on a pro rata minimum distribution from consolidated earnings and profits of the group:					
Pro rata minimum distribution (and amount which would be received by M Corporation):					
(0.40 × $18)	7.20				
(0.40 × $15)		6.00			
(0.40 × $5)			2		
(0.40 × $40)				16	31.20
Gross-up under sec. 78:					
($7.20/$18 × $2)	.80				
($6/$15 × $15)		6.00			
($2/$5 × $5)			2		8.80
Taxable income of M Corporation ($31.20 + $8.80)					40.00
U.S. tax before foreign tax credit (0.52 × $40)					20.80
Foreign tax credit ($8.80, as computed under the gross-up, plus 40 percent of $20)					16.80
U.S. tax payable ($20.80 – $16.80)					4.00
Overall U.S. and foreign income tax with respect to a pro rata minimum distribution for 1963 ($4 + $42)					46.00
Tentative tax on distribution actually received by M Corporation:					
Actual distribution received			5	40	45.00
Gross-up under sec. 78 ($5/$5 × $5)			5		5.00
Taxable income of M Corporation ($45 + $5)					50.00
U.S. tax before foreign tax credit (0.52 × $50)					26.00
Tentative foreign tax credit ($5, as computed under the gross-up above, plus 100 percent of $20)					25.00

	Branch	C	D	Total	
Tentative U.S. tax payable ($26 − $25)					1.00
Insufficient overall U.S. and foreign income tax (the lesser of $46 or $46.80 [0.90×0.52×$100] minus $43 [$1+$42])					3.00
Reduced foreign tax credit ($25 − $3)					22.00
U.S. tax payable ($26 − $22)					4.00
Overall U.S. and foreign income tax with respect to actual distribution for 1963 ($4+$42)					46.00
Reduction in foreign tax credit for 1963 ($25 − $22)					3.00
Allocation of reduction in foreign tax credit to undistributed 1963 consolidated earnings and profits of the group:					
($18/[$18+$15]×$3.00)	1.64				
($15/[$18+$15]×$3.00)		1.36			3.00

Example (7). Domestic group M, an affiliated group of domestic corporations filing a consolidated return under section 1501, makes a group election for 1963 with respect to a group consisting of two controlled foreign corporations C and D, all of whose one class of stock is directly owned by group M, and foreign branch B, a foreign branch of a Western Hemisphere trade corporation (as defined in section 921) included in group M. No distributions are received for the taxable year from corporations C and D, but the foreign group makes a minimum distribution by reason of the deemed distribution of all of branch B's earnings and profits. Group M complies with the special rules of paragraphs (b) and (c) of this section. For 1963, a year for which the United States corporate income tax rate is 52 percent, the overall limitation under section 904(a)(2) on the foreign tax credit applies. All corporations use the calendar year as the taxable year. None of the foreign corporations is a less developed country corporation under section 902(d) for 1963. The income, and the United States and foreign income tax for 1963, are determined as follows, based upon the facts assumed:

	Branch	C	D	Total
Pretax and predistribution consolidated earnings and profits of the foreign group (before Western Hemisphere trade corporation deduction)	$100.00	$10.00	$10.00	$120.00
Western Hemisphere trade corporation deduction ($100×0.14/0.52)	26.92			26.92
Pretax and predistribution consolidated earnings and profits of the foreign group (after Western Hemisphere trade corporation deduction)	73.08	10.00	10.00	93.08
Consolidated foreign income taxes (38%, 20%, and zero rate, respectively):				
(0.38×$100)	38.00			
(0.20×$10)		2.00		40.00
Consolidated earnings and profits of the foreign group	35.08	8.00	10.00	53.08
Effective foreign tax rate ($40/$93.08)				43%
Statutory percentage under sec. 963(b)				40%
Tax which would be paid with respect to a pro rata minimum distribution from consolidated earnings and profits of the foreign group:				
Pro rata minimum distribution:				
(0.40×$73.08)	29.23			
(0.40×$8.00)		3.20		
(0.40×$10.00)			4.00	36.43
Gross-up under sec. 78: ($3.20/$8.00×$2)		.80		.80
Taxable income of group M	29.23	4.00	4.00	37.23
U.S. tax before foreign tax credit:				
(0.52×$29.23)	15.20			
(0.54×$4.00)		2.16		
(0.54×$4.00)			2.16	19.52
Foreign tax credit ($0.80, as computed under the gross-up above, plus 40 percent of $38)	15.20	.80		16.00
U.S. tax payable		1.36	2.16	3.52
Overall U.S. and foreign income tax with respect to pro rata minimum distribution ($3.52+$40)				43.52
Tentative tax on distribution actually received by group M:				
Taxable income of branch	73.08			73.08
U.S. tax before foreign tax credit (0.52×$73.08)	38.00			38.00
Tentative foreign tax credit	38.00			38.00
Tentative U.S. tax payable				0
Insufficient overall U.S. and foreign income tax (the lesser of $43.52 or $43.56 [0.90×0.52×$93.08] minus $40)				3.52
Reduced foreign tax credit ($38 − $3.52)				34.48
U.S. tax payable ($38 − $34.48)				3.52

	Branch	C	D	Total
Overall U.S. and foreign income tax ($3.52 + $40.00)				43.52
Reduction in foreign tax credit for 1963 ($38 – $34.48)				3.52
Allocation of reduction in foreign tax credit to 1963 undistributed consolidated earnings and profits of the foreign group:				
($8/[$8 + $10] × $3.52)		1.56		
($10/[$8 + $10] × $3.52)			1.96	3.52

[T.D. 6759, 29 FR 13335, Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14878, Nov. 3, 1964; T.D. 7100, 36 FR 5336, Mar. 20, 1971]

§ 1.963-5 Foreign corporations with variation in foreign tax rate because of distributions.

(a) *Limited application of section.* The rules of this section shall apply to a foreign corporation only if—

(1) Under the laws of a foreign country or possession of the United States the foreign income tax of the corporation for the taxable year depends upon the extent to which distributions are made by such corporation from its earnings and profits for the taxable year, so that the rate of such tax for the taxable year on income which is distributed differs from the rate of such tax for such year on the income which is not distributed, and

(2) The corporation—

(i) Is a single first-tier corporation, or

(ii) Is for the taxable year in a chain or group from which the United States shareholder receives a minimum distribution in respect of which the minimum overall tax burden is determined in accordance with paragraph (a)(1)(ii) of § 1.963-4.

(b) *Foreign income tax determined as though no distributions were made.* The foreign income tax on the pretax and predistribution earnings and profits of the foreign corporation for the taxable year shall (solely for the purpose of determining the effective foreign tax rate under paragraph (c) of § 1.963-2) be determined as if the foreign corporation made no distributions for the taxable year. However, notwithstanding the second sentence of paragraph (d)(1) of § 1.963-2, where the United States shareholder owns the stock (with respect to which the election under section 963 is made) in such corporation by reason of stock owned through a chain of ownership described in section 958(a) and the foreign income tax of such corporation for the taxable year decreases as distributions are made from its earnings and profits, the rule in the preceding sentence shall not apply if the electing United States shareholder does not actually receive for the taxable year its proportionate share of the earnings and profits which are actually distributed. In such case, the foreign income tax on pretax and predistribution earnings and profits shall be the actual foreign income tax of such corporation, computed on the basis of the distributions which are made. For example, assume that a second-tier foreign corporation in a chain has pretax and predistribution earnings of $100 for the taxable year and that foreign law imposes on such corporation a foreign income tax of 50 percent of the pretax earnings and profits minus dividends for such year and of 20 percent of such dividends. If the second-tier foreign corporation distributes $20 of earnings and profits to a first-tier foreign corporation which is part of the same chain, and if the first-tier corporation retains the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be the tax actually paid for the taxable year, that is, $44 (50 percent of $80 plus 20 percent of $20). If the first-tier foreign corporation distributes the dividend so received, the foreign income tax of the second-tier foreign corporation shall be considered to be $50 (50 percent of $100). For purposes of this paragraph, the principles of paragraph (b)(3) of § 1.963-4 shall apply.

(c) *Minimum distribution*—(1) *Single first-tier corporation.* A minimum distribution for a taxable year by a single first-tier corporation described in paragraph (a)(1) of this section shall be a distribution which is equal to—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of § 1.963-2 for such year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(2)(i) of § 1.963-2 but without the deduction for foreign income tax provided by paragraph (d)(1)(ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(2) *Corporation in a chain or group making a pro rata minimum distribution.* In case of a corporation described in paragraph (a)(2)(ii) of this section in a chain or group, such corporation's share of a pro rata minimum distribution by the chain or group for the taxable year shall be—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of § 1.963-2 for the taxable year by the United States shareholder's proportionate share of the earnings and profits of such corporation, as determined under paragraph (d)(3) of § 1.963-2 but without the deduction for foreign income tax provided by paragraph (d)(1) (ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by such corporation by reason of distributing such amount, less such tax, for such taxable year.

(3) *A chain or group making a distribution other than a pro rata minimum distribution.* If a chain or group contains one or more foreign corporations described in paragraph (a)(2)(ii) of this section and such chain or group makes a minimum distribution other than a pro rata minimum distribution for the taxable year, the amount of such minimum distribution to the electing United States shareholder shall be at least—

(i) The amount resulting from the multiplication of the statutory percentage specified in paragraph (b) of § 1.963-2 for the taxable year by the consolidated earnings and profits of such chain or group with respect to such shareholder, as determined under paragraph (d)(3) of such section but without any deduction for foreign income tax provided by paragraph (d)(1) (ii) and (iii) of such section, reduced by

(ii) The foreign income tax on the pretax amount determined under subdivision (i) of this subparagraph which would be paid or accrued by the foreign corporations in the chain or group by reason of distributing such amount, less such tax, for such taxable year.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Domestic corporation M directly owns 80 percent of the one class of stock of single first-tier corporation B, which for 1964 has $100 of pretax earnings and profits on which is imposed a foreign income tax of 40 percent of pretax earnings and profits minus dividends for the taxable year and of 20 percent of the amount of such dividends. Both corporations use the calendar year as the taxable year. The effective foreign tax rate applicable to B Corporation, as determined under paragraph (c) of § 1.963-2, is 40 percent, and the statutory percentage under paragraph (b) of § 1.963-2 for 1964 is 38 percent. Corporation M receives a minimum distribution for 1964 if it receives from B Corporation's earnings and profits for such year $22.80, that is, 80 percent of $28.50, the distribution which would be made if there were distributed that amount of earnings and profits which, together with the foreign income tax at the rate effectively applicable to pretax earnings and profits to which such distribution is attributable, equals 38 percent of $100. Such distribution may be determined by solving for "d" in the following formula:

$$d = \$38 - 0.20d - 0.40(\$38 - d)$$

$$d = \$38 - 0.20d - \$15.20 + 0.40d$$

$$d = \$22.80 + 0.20d$$

$$0.80\ d = \$22.80$$

$$d = \$22.80/0.80$$

$$d = \$28.50$$

Example (*2*). Domestic corporation M directly owns 80 percent of the one class of stock of each of controlled foreign corporations A and B, which constitute a group and each of which for 1964 has pretax earnings and profits of $100. All corporations use the calendar year as the taxable year. Corporation A is subject to foreign income tax at a flat rate of 40 percent; and B Corporation is subject to a foreign income tax of 40 percent of $100 minus dividends for the taxable year and of 20 percent of the amount of such dividends. The effective foreign tax rate with respect to the group, as determined under paragraph (c) of § 1.963-2, is 40 percent, and the statutory percentage under paragraph (b) of § 1.963-2 for 1964 is 38 percent. Corporation B distributes $25 for 1964 toward a minimum distribution from the group which is not a pro rata minimum distribution. The minimum distribution by the group for 1964 with respect to M Corporation is determined as follows:

M Corporation's proportionate share of B Corporation's distribution (0.80 × $25)	$20.00
Pretax and predistribution consolidated earnings and profits of the group (0.80 × $200)	160.00
Statutory percentage of pretax and predistribution consolidated earnings and profits (0.33 × $160)	60.80
Less: portion of such statutory percentage to which the $20 dividend received from B Corporation is attributable: Total dividend paid by B Corporation	25.00
Plus: Foreign income tax on B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable, letting "t" represent such tax:	
t = 0.20 ($25) + 0.40t	
t = $5 + 0.40t	
0.60t = $5	
t = $5/0.60	8.33
B Corporation's pretax and predistribution earnings and profits to which such dividend is attributable	33.33
M Corporation's proportionate share of B Corporation's pretax and predistribution earnings and profits to which the dividend is attributable (0.80 × $33.33)	26.67
The statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which A Corporation's distribution must be attributable	34.13
Dividend required to be received from A Corporation ($34.13 − [0.40 × $34.13])	20.48
Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20 + $20.48)	40.48

Example (*3*). The facts are the same as in example (2) except that the $25 distribution of earnings and profits is made by A Corporation. The amount of the minimum distribution for 1964 is determined as follows:

M Corporation's proportionate share of A Corporation's distribution (0.80 × $25)	$20.00
Pretax and predistribution consolidated earnings and profits of the group (0.80 × $200)	160.00
Statutory percentage of pretax and predistribution consolidated earnings and profits (0.38 × $160)	60.80
Less: Portion of such statutory percentage to which the $20 dividend received from A Corporation is attributable: Total dividend paid by A Corporation	25.00
Plus: Foreign income tax on A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable (0.40 × [$25/0.60])	16.67
A Corporation's pretax and predistribution earnings and profits to which such dividend is attributable	41.67
M Corporation's proportionate share of A Corporation's pretax and predistribution earnings and profits to which dividend is attributable ($41.67 × 0.80)	33.34
Portion of the statutory percentage of the pretax and predistribution consolidated earnings and profits of the group to which B Corporation's distribution must be attributable	27.46
Dividend received from B Corporation, letting "d" represent the dividend:	
d = $27.46 − 0.20d − 0.40 ($27.46 − d)	
d = $27.46 − 0.20d − $10.98 + 0.40d	
d = $16.48 + 0.20d	
0.80d = $16.48	
d = $16.48/0.80	20.60
Minimum distribution to M Corporation of the taxable year's consolidated earnings and profits of the group ($20 + $20.60)	40.60

(d) *Distributions through a chain or group.* In the application of paragraph (b)(3)(i) of § 1.963-4, relating to the allocation of dividend payments first to income received as a distribution from other foreign corporations in the chain or group, if one or more of such other foreign corporations is a corporation whose foreign income tax rate decreases as the distributions are made, the allocation under such paragraph shall be made first to such corporations' distributions.

(e) *Foreign tax credit*—(1) *Year of minimum distribution.* If a United States shareholder receives for a taxable year a distribution of the earnings and profits for the taxable year of a foreign corporation described in paragraph (a) of this section and if for such year such corporation is a first-tier corporation, or a second-tier corporation described in section 902 (a) or (b), as the case may be, then, in applying paragraph (c)(2)(i) of § 1.963-4, only the foreign income tax which is effectively applicable to pretax earnings and profits to which are attributable the earnings and profits which are distributed shall be deemed paid for such year under section 902 (a) or (b), as the case may be, and the foreign income tax so paid or accrued by such corporation shall not be averaged, for purposes of such section, with its foreign income tax paid or accrued for such year on its pretax earnings and profits to which are attributable the earnings and profits which are not distributed.

(2) *Year of distribution of remaining earnings and profits.* If for a taxable year a United States shareholder receives a minimum distribution from a corporation described in paragraph (a) of this section, the pretax and predistribution earnings and profits of such corporation for the taxable year to which such minimum distribution is attributable and the foreign income tax which is taken into account, in accordance with paragraph (c)(2)(i) of § 1.963-4, in determining tax deemed paid under section 902 on such pretax and predistribution earnings and profits shall not be taken into account in the application of section 902 when other earnings and profits of such foreign corporation for such year are distributed in a subsequent taxable year of such foreign corporation to such shareholder.

(3) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example (1). (a) All the income of controlled foreign corporation B, wholly owned directly by domestic corporation M, is taxed by foreign country Y, the tax laws of which impose at the local level a corporate income tax of 10 percent of earnings and profits (before reduction for income taxes) and, at the national level, an income tax of 30 percent of such earnings and profits reduced by the local tax and by any profits which are distributed. Also, at the national level, a tax of 20 percent is imposed on B Corporation on the dividends which are paid for the taxable year. Both corporations use the calendar year as the taxable year. For 1963, B Corporation has earnings and profits (before reduction by income taxes) of $100. B Corporation is not a less developed country corporation under section 902(d). For 1963, M Corporation makes a first-tier election with respect to B Corporation and receives a minimum distribution. Corporation B has no 1964 earnings and profits, and its remaining 1963 earnings and profits are distributed late in 1964. The amount of the minimum distribution required to be received by M Corporation for 1963 and the United States tax with respect to the 1963 earnings and profits of B Corporation are determined as follows, assuming a United States corporate income tax rate of 52 percent (instead of 50 percent) for 1964 and no surtax exemption under section 11(c) for either year:

1963

Effective foreign tax rate which obtains if no earnings and profits of B Corporation are distributed [($100×0.10)+ ([$100−($100×0.10)]×0.30)]/$100	37%
Minimum percentage of earnings and profits required under sec. 963(b) to be distributed, given a 37 percent effective foreign tax rate	68%
Amount of earnings and profits (before reduction by foreign income tax) to which minimum distribution would be attributable if the effective foreign tax rate of 37 percent obtained (0.68×$100)	$68.00
Minimum distribution required to be received by M Corporation, i.e., such an amount that is $68 less the foreign income tax on such $68, determined by letting "d" equal the dividend in the algebraic equation:	
d=$68 − (0.10 × $68) − 0.30 ($68 − [0.10 × $68] − d) − 0.20d	
d=$68 − $6.80 − ($20.40 − $2.04 − 0.30d) − 0.20d	
d=$61.20 − $20.40 + $2.04 + 0.30d − 0.20d	
d=$42.84 + 0.10d	
0.90d=$42.84	
d=$42.84/0.90, or	$47.60
Gross-up under sec. 78, using the actual foreign income tax imposed on pretax profits to which are attributable the earnings and profits distributed ($6.80+0.30 [$61.20−$47.60]+0.20 [$47.60])	$20.40
Taxable income of M Corporation for 1963 ($47.60+$20.40)	$68.00
U.S. tax before foreign tax credit ($68×0.52)	$35.36
Foreign tax credit ($47.60/$47.60× $20.40)	$20.40
U.S. tax payable for 1963 ($35.36− $20.40)	$14.96
Overall U.S. and foreign income tax rate [$14.96+$20.40+($32×0.37)]/$100	47.20%

1964

Dividend received by M Corporation ($32−[0.37×$32])	$20.16
Gross-up under sec. 78, using the foreign income tax paid or accrued on pretax earnings and profits to which are attributable 1963 earnings and profits distributed during 1964 ($20.16/$20.16×[$32× 0.37])	$11.84
Taxable income of M Corporation for 1964 ($20.16+$11.84)	$32.00
U.S. tax before foreign tax credit ($32×0.52)	$16.64
Foreign tax credit ($20.16/$20.16× $11.84)	$11.84
U.S. tax payable ($16.64−$11.84)	$4.80

(b) If B Corporation were a less developed country corporation under section 902(d), there would be no gross-up under section 78 and the foreign tax credit of M Corporation would be $14.28 for 1963 ($47.60/[47.60+

$20.40]×$20.40), and $7.46 for 1964 ($20.16/[$20.16+$11.84]×$11.84).

Example (2). For 1963, domestic corporation M receives a dividend of $21 from B Corporation which counts toward a minimum distribution from a group, determined by applying the special rules of paragraphs (b) and (c) of § 1.963-4. Both corporations use the calendar year as the taxable year. Foreign law imposes on B Corporation an income tax of 40 percent of the year's pretax earnings and profits, less dividends paid for such year, and of 20 percent of such dividends. Corporation M directly owns 70 percent of the one class of stock of B Corporation, which for 1963 has pretax and predistribution earnings and profits of $100. Corporation B is not a less developed country corporation under section 902(d). In late 1964, M Corporation receives a distribution of all of B Corporation's 1964 earnings and profits and of $25.20 from its 1963 earnings and profits. The foreign income tax of B Corporation deemed paid for 1963 by M Corporation under section 902(a) is based on the foreign income tax actually paid by B Corporation on an amount of pretax earnings and profits which, when reduced by the tax so paid, equals the total dividend which is paid. The determination of tax deemed paid by M Corporation with respect to distributions from 1963 earnings and profits of B Corporation is as follows:

1963

Pretax and predistribution earnings and profits of B Corporation for 1963	$100
Total dividend paid by B Corporation in 1963 ($21/0.70)	30
Total foreign income tax paid by B Corporation for 1963 (0.40[$100 − $30] + [0.20×$30]) or ($28+$6)	34
Foreign income tax, represented by "t" in the following equation, to be taken into account with respect to total dividend in determining tax deemed paid under sec. 902(a) by M Corporation:	
t=(0.20×$30)+0.40t	
t=$6+0.40t	
0.60t=$6	
t=$6/0.60, or	10
Foreign income tax deemed paid by M Corporation for 1963 ($21/$30×$10)	7

1964

Remaining 1963 earnings and profits of B Corporation ([$100−$34]−$30) or ($66−$30)	36
Dividend received by M Corporation for 1964 (0.70×$36)	25.20
Foreign income tax deemed paid by M Corporation for 1964 ($25.20/$36× [$34−$10]) or ($25.20/$36×$24)	16.80

[T.D. 6759, 29 Sept. 25, 1964; 29 FR 13896, Oct. 8, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

§ 1.963-6 Deficiency distribution.

(a) *In general.* Section 963(e)(2) and this section provide a method under which, by virtue of a deficiency distribution, a United States shareholder may be relieved from the payment of a deficiency in tax for any taxable year arising by reason of failure to include subpart F income in gross income under section 951(a)(1)(A)(i), when it has been determined that such shareholder has failed to receive a minimum distribution for such year in respect of which it elected to secure the exclusion under section 963. In addition, this section provides rules with respect to a credit or refund of part or all of any such deficiency which has been paid. Under the method provided, the benefit of the exclusion of subpart F income from gross income of the United States shareholder is allowed retroactively for the taxable year in respect of which the election under section 963 applied, but only if the subsequent deficiency distribution meets the requirements of this section. The benefits of the retroactive exclusion will not, however, prevent the assessment of interest, additional amounts, and assessable penalties.

(b) *Requirements for deficiency distribution*—(1) *Distribution made on or after date of determination.* If—

(i) A United States shareholder, in making its return of the tax imposed by chapter 1 of the Code for any taxable year, elects to secure an exclusion under section 963 for such year,

(ii) It is subsequently determined (within the meaning of paragraph (c) of this section) that an exclusion under section 963 of subpart F income with respect to stock to which such election relates does not apply for such taxable year because of the failure of such shareholder to receive a minimum distribution for such year with respect to such stock, and

(iii) Such failure is due to reasonable cause, a deficiency distribution which is received by such shareholder with respect to such stock from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if such deficiency distribution is received (except as provided by subparagraph (2) of this paragraph) on, or within 90 days after, the date of such determination and prior to the filing of a claim under paragraph (d)(1) of this section. Such claim must be filed within 120 days after the date of such determination, and the deficiency distribution must be a dividend of such a nature (except as otherwise provided in this section) as would have permitted it to count toward a minimum distribution for the taxable year of the election if it had been received by the United States shareholder during such year. No distribution shall count as a deficiency distribution under this subparagraph unless a claim therefor is filed under paragraph (d)(1) of this section.

(2) *Distribution made before date of determination.* A deficiency distribution may also be received by a United States shareholder at any time prior to the date on which the determination required by subparagraph (1) of this paragraph is made. A distribution will count as a deficiency distribution under this subparagraph—

(i) To the extent that such distribution otherwise satisfies the requirements of this section;

(ii) If the United States shareholder files within 90 days after such distribution but before the determination date an advance claim described in paragraph (d)(2) of this section for treatment of such distribution as a deficiency distribution;

(iii) If such shareholder consents in such claim to include such deficiency distribution in gross income for the taxable year of the election to the extent necessary to complete a minimum distribution for such year and under section 6501 to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties for such taxable year;

(iv) If, when requested by the district director, such shareholder consents under section 6501 in such claim to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts and assessable penalties for the year of receipt of such distribution; and

(v) To the extent that such shareholder makes advance payment of tax which would result from the inclusion of such distribution in gross income as a minimum distribution for the year of such deficiency.

To the extent that such distribution is not necesasry under the determination (when made under paragraph (c) of this section) for a deficiency distribution, it shall be included in the United States shareholder's gross income for the taxable year of receipt of such distribution and paragraph (g) of this section shall not apply.

(3) *Earnings and profits of year of election to be first distributed.* If—

(i) In the case of a first-tier election, the United States shareholder's proportionate share of the earnings and profits of the foreign corporation which was the single first-tier corporation, or

(ii) In the case of a chain or group election, any portion of the share of any corporation or corporations (which were in the chain or group) of the consolidated earnings and profits with respect to the United States shareholder,

for the taxable year of the election has not been distributed on the stock with respect to which the election was made, then a distribution, in order to be counted toward a deficiency distribution, must be made by such corporation or corporations and from such earnings and profits to the extent thereof. Once all such earnings and profits of such corporation or corporations have been completely distributed, a deficiency distribution may be made from other earnings and profits of such foreign corporation which was a single first-tier corporation, or of such corporation or corporations which were in such chain or group, as the case may be.

(4) *Proof of reasonable cause.* Reasonable cause for failure to receive a minimum distribution shall be deemed to exist, in the absence of circumstances demonstrating bad faith, if the

electing United States shareholder receives, within the period prescribed by paragraph (a)(1)(i) of § 1.963-3 with respect to the year of election, at least 80 percent of the amount of a minimum distribution (from the earnings and profits to which the election for such year relates) which if received during such period would have satisfied the conditions for the section 963 exclusion to apply to such year. If less than 80 percent of the amount of a minimum distribution is received during such period, the existence of a reasonable cause for failure to receive a minimum distribution must be established by clear and convincing evidence; however, the preceding sentence shall not be taken as a limitation on the establishment of reasonable cause by any other proof of reasonable cause. For example, reasonable cause will exist if a single first-tier corporation for its taxable year makes a distribution which would be a minimum distribution but for a refund of foreign income tax which it has paid in good faith under foreign law but which is found not to be due after the United States income tax return of the United States shareholder has been filed.

(c) *Nature and details of determination.* (1) A determination that the section 963 exclusion does not apply to a United States shareholder for a taxable year due to its failure to receive a minimum distribution for such year shall, for the purposes of this section, be established by—

(i) A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(ii) A closing agreement made under section 7121; or,

(iii) An agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated, and by, or on behalf of, such shareholder and which relates to the liability of such shareholder for the tax under chapter 1 of the Code for such year.

(2) The date of determination by a decision of the Tax Court shall be the date upon which such decision becomes final, as prescribed in section 7481.

(3) The date upon which a judgment of a court becomes final shall be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court shall become final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims shall become final upon the expiration of the time allowed for filing a petition for certiorari, if no such petition is duly filed within such time.

(4) The date of determination by a closing agreement made under section 7121 shall be the date such agreement is approved by the Commissioner.

(5) The date of a determination made by an agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated, shall be the date prescribed by this subparagraph. The agreement shall be sent to the United States shareholder at his last known address by either registered or certified mail. If registered mail is used for such purpose, the date of registration shall be treated as the date of determination; if certified mail is used for such purpose, the date of the postmark on the sender's receipt for such mail shall be treated as the date of determination. However, if the deficiency distribution is received by such shareholder before such registration or postmark date but on or after the date the agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be the date on which the agreement is so signed.

(6) The determination under this paragraph shall find that, due to the United States shareholder's failure to receive a minimum distribution, the section 963 exclusion does not apply for the taxable year with respect to stock to which the election under such section relates. A determination described in subdivision (ii) or (iii) of subparagraph (1) of this paragraph shall set forth the amount of the deficiency distribution and the amount of additional income tax for which the United States shareholder is liable under chapter 1 of the Code by reason

of not including in gross income for such year the amount of the deficiency distribution. If a determination described in subdivision (i) of subparagraph (1) of this paragraph does not establish the amount of the deficiency distribution and such amount of additional tax, such amounts may be established by an agreement which is signed by the district director, or such other official to whom authority to sign the agreement is delegated.

(d) *Claim for treatment of distribution as a deficiency distribution*—(1) *Claim filed after date of determination.* A claim (including any amendments thereof) for treatment of a deficiency distribution as counting toward a minimum distribution for the taxable year of election shall be filed in duplicate, within 120 days after the date of the determination described in paragraph (c) of this section, with the requisite declaration prescribed by the Commissioner on the appropriate claim form and shall be accompanied by—

(i) A copy of such determination and a description of how it became final;

(ii) If requested by the district director, or by such other official to whom authority to sign the agreement referred to in paragraph (c) (1) or (6) of this section is delegated, a consent by the United States shareholder under section 6501 to extend the period for the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of a deficiency and all interest, additional amounts, and assessable penalties for the taxable year of election; and

(iii) Such other information as may be required by the claim form or the district director, or other official, in support of the claim.

(2) *Advance claim.* An advance claim for treatment of a deficiency distribution as counting toward a minimum distribution for the taxable year of election shall be filed in duplicate, within 90 days after such distribution but before the date of determination described in paragraph (c) of this section, and shall satisfy all requirements of subparagraph (1) of this paragraph other than subdivision (i) of such subparagraph. However, within 120 days after the date of the determination described in paragraph (c) of this section, the advance claim shall be completed so that it satisfies all requirements of subparagraph (1) of this paragraph.

(e) *Computation of interest on deficiencies in tax.* If a United States shareholder, for the taxable year of the election under section 963, completes a minimum distribution for such year by receiving a deficiency distribution to which this section applies, the interest on the deficiency in tax due by reason of the failure to include the amount of such deficiency distribution in such shareholder's gross income for such year shall be computed for the period from the last date prescribed for payment of the tax for such year to the date such deficiency in tax is paid. No interest shall be due by reason of the failure to include subpart F income in gross income for a taxable year in respect of which a minimum distribution under section 963 is completed by a deficiency distribution to which this section applies.

(f) *Claim for credit or refund.* If a deficiency in tax is asserted for any taxable year by reason of failure to include subpart F income in gross income under section 951(a)(1)(A)(i) and the United States shareholder has paid any portion of such asserted deficiency, such shareholder is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment of tax as the result of the receipt of a deficiency distribution to which this section applies. To secure credit or refund of such overpayment of tax, the United States shareholder must file a claim for refund in accordance with § 301.6402-3, in addition to the claim form required under paragraph (d) of this section. No interest shall be allowed on such credit or refund. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see section 6402 and the regulations thereunder. For the limitations applicable to the credit or refund for an overpayment of tax, see section 6511 and the regulations thereunder.

(g) *Effect of deficiency distribution*—(1) *Allocation of distributions.* The deficiency distribution shall be allocated, by applying the rules of § 1.963-3 (and paragraph (b) of § 1.963-4, if applicable for the year of election), as a distribution first from the earnings and profits (to the extent thereof) of the foreign corporation which was the single first-tier corporation, or of the distributing corporation or corporations which were in the chain or group, as the case may be, for the taxable year in respect of which the election was made, and then from earnings and profits (to the extent thereof) described in section 959(c)(3) and determined as provided in section 959 for the most recent taxable year and the first, second, etc., taxable years preceding such recent taxable years, in that order, of the distributing corporation or corporations. In applying the preceding sentence to taxable years other than the taxable year in respect of which the election was made, the deficiency distribution shall first be allocated, in the order of allocation prescribed by such sentence, first to taxable years in respect of which no election under section 963 was made with respect to the stock on which such distribution is received and then to taxable years in respect of which an election under such section was made.

(2) *Year of receipt.* Any deficiency distribution made with respect to a taxable year of the United States shareholder shall be treated, except as provided in paragraph (b)(2) of this section, as having been received by the shareholder in that year for which such shareholder elected to secure an exclusion under section 963; and, for purposes of the foreign tax credit under section 901, the foreign income taxes paid or accrued, or deemed paid, by the United States shareholder by reason of a distribution of any amount treated as a deficiency distribution for such year shall be treated as paid or accrued, or deemed paid, for such year.

(3) *Year of payment.* A distribution counting toward a deficiency distribution for a taxable year of election shall, except as provided in paragraph (b)(2) of this section, be treated for purposes of applying paragraph (a) of § 1.963-3, relating to conditions under which earnings and profits are counted toward a minimum distribution, and paragraph (b)(3) of § 1.963-4, relating to rules for distributing through a chain or group, as if it were distributed during the distribution period (as defined in paragraph (g) of § 1.963-3) with respect to the distributing corporation and each foreign corporation through which such distribution is made to the United States shareholder, for the taxable year to which the election under section 963 applies; and the foreign income taxes paid by any foreign corporation by reason of such distribution shall, in the application of section 902 and of the special rules of paragraph (c) of § 1.963-4, be treated as paid or accrued by such foreign corporation for its taxable year to which such election applies. The distribution shall not count toward a minimum distribution for any other taxable year.

(4) *Allocation of reduction in tax credit.* If any portion of a deficiency distribution from a corporation which was in a chain or group is paid from earnings and profits of a taxable year other than that in respect of which the election was made, then the minimum distribution toward which such deficiency distribution counts may not be treated as a pro rata minimum distribution for purposes of § 1.963-4. Moreover, the amount of the overall United States and foreign income tax with respect to such minimum distribution must satisfy the minimum tax requirements of paragraph (a)(1)(i), or paragraph (a)(1)(ii), of § 1.963-4, but, if the latter applies, without any reduction and deferral under paragraph (c)(3) of such section of the foreign tax credit allowable under section 901 with respect to the deficiency distribution.

[T.D. 6759, 29 FR 13346, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964; T.D. 7410, 41 FR 11020, Mar. 16, 1976]

§ 1.963-7 Transitional rules for certain taxable years.

(a) *Extension of time for making, revoking, or changing election*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph provide additional rules which apply only to a taxable year of a United States shareholder for which the last day prescribed by law for filing its return (including any extensions of time under section 6081) occurs on or before the 90th day after September 30, 1964.

(2) *Manner of making the election.* The election of the United State shareholder to secure the exclusion under section 963 and the consent to the regulations under such section may be made for the taxable year—

(i) By filing with the return (or with an amended return filed on or before such 90th day) for such taxable year—

(*a*) A written statement stating that such election is made for such taxable year, and

(*b*) The names of the foreign corporations to which such election applies, the taxable year, country of incorporation, pretax earnings and profits, foreign income taxes, earnings and profits, and outstanding capital stock, of each such corporation, and such other information relating to the election made as the Commissioner may prescribe, on or before the date of filing, by instructions or schedules to support such return; or

(ii) In case of any extension of time under section 6081 with respect to such taxable year where the last day prescribed by law for filing the return by the electing United States shareholder (not including any extensions thereof) occurs on or before September 30, 1964, by filing with the request for the first such extension of time a written statement stating that such election is made for such taxable year and setting forth the names of the foreign corporations to which each election applies.

(3) *Revocation or change of election.* An election made in the manner provided by subparagraph (2) of this paragraph may be revoked or changed—

(i) By filing with the return on or before the 90th day after September 30, 1964, a written statement that such election is revoked or changed, as the case may be, and by setting forth with respect to any such modified election the information prescribed by subparagraph (2)(i)(*b*) of this paragraph, or

(ii) Where the return has been filed on or before such 90th day, by filing on or before such 90th day an amended return and an accompanying statement that such election is revoked or changed, as the case may be, and by setting forth with respect to any such modified election the information prescribed by subparagraph (2)(i)(*b*) of this paragraph.

(b) *Extension of time for making a minimum distribution*—(1) *In general.* This paragraph applies only with respect to a taxable year of a United States shareholder ending on or before September 30, 1964, for which an election to secure an exclusion under section 963 is made where, in case of a first-tier election, the distribution period of such first-tier corporation with respect to its taxable year to which such election applies ends on or before the 90th day after such date, and where, in the case of a chain or group election, the distribution period ends on or before such 90th day with respect to the taxable year to which the election applies of any of the foreign corporations in such chain or group.

(2) *Conditions for obtaining extension of time.* A distribution on stock with respect to which the election under section 963 was made which is received by the United States shareholder from a foreign corporation which was the single first-tier corporation, or a corporation in the chain or group, as the case may be, with respect to which the election was made, shall count toward a minimum distribution under section 963 for such year of election if—

(i) The distribution is made on or before such 90th day,

(ii) The shareholder, in a statement attached to its return or amended return for such year (which is filed on or before such 90th day) indicates the foreign corporation or corporations from which the distribution is made and states that, and the extent to which, the distribution is to count toward such minimum distribution,

(iii) The distribution is of such a nature as would have permitted it to count toward a minimum distribution for such taxable year of the United States shareholder if it had been made on the last day of such year, and

(iv) The United States shareholder includes the distribution in gross income as if it were received on the last day of such taxable year of election.

The distribution shall be applied against the earnings and profits of the single first-tier corporation or the foreign corporations in the chain or group for the taxable year of such corporation or corporations to which the election applies.

(3) *Year of receipt.* To the extent that a distribution counts toward a minimum distribution under this paragraph with respect to a taxable year of the United States shareholder, it shall be treated as having been received by the shareholder in that year for the purpose of determining gross income and the assessment of interest, additional amounts, and assessable penalties; and, for purposes of the foreign tax credit under section 901, the foreign income taxes paid or accrued, or deemed paid, by the United States shareholder by reason of a distribution of any amount treated as a distribution for such year under this paragraph shall be treated as paid or accrued, or deemed paid, for such year.

(4) *Year of payment.* The distribution shall be treated for purposes of applying paragraph (a) of § 1.963-3, relating to conditions under which earnings and profits are counted toward a minimum distribution, and paragraph (b)(3) of § 1.963-4, relating to rules for distributing through a chain or group, as if it were distributed during the distribution period (as defined in paragraph (g) of § 1.963-3) with respect to the distributing corporation and each foreign corporation through which such distribution is made to the United States shareholder, for the taxable year to which the election under section 963 applies; and the foreign income taxes paid by any foreign corporation by reason of such distribution shall, in the application of section 902 and of the special rules of paragraph (c) of § 1.963-4, be treated as paid or accrued by such foreign corporation for its taxable year to which such election applies. The distribution shall not count toward a minimum distribution for any other taxable year.

[T.D. 6759, 29 FR 13348, Sept. 25, 1964, as amended by T.D. 6767, 29 FR 14879, Nov. 3, 1964]

§ 1.963-8 Determination of minimum distribution during the surcharge period.

(a) *Taxable years not wholly within the surcharge period.* In the case of a taxable year beginning before the surcharge period and ending within the surcharge period, or beginning within the surcharge period and ending after the surcharge period, or beginning before January 1, 1970, and ending after December 31, 1969, section 963(b) provides the method for determining the required minimum distribution. Under the method prescribed in section 963(b) for such years, the required minimum distribution is an amount equal to the sums of:

(1) That portion of the minimum distribution which would be required if the provisions of section 963(b)(1) were applicable to the taxable year, which the number of days in such taxable year which are within the surcharge period and before January 1, 1970, bears to the total number of days in such taxable year.

(2) That portion of the minimum distribution which would be required if the provisions of section 963(b)(2) were applicable to such taxable year, which the number of days in such taxable year which are within the surcharge period and after December 31, 1969, bears to the total number of days in such taxable year, and

(3) That portion of the minimum distribution which would be required if the provisions of section 963(b)(3) were applicable to such taxable year, which the number of days in such taxable year which are not within the surcharge period bears to the total number of days in such taxable year.

(b) *Calendar year 1970.* For calendar year 1970, the required minimum distribution shall be an amount determined in accordance with the following table:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 9	84.983562
9 or over but less than 10	82.967123
10 or over but less than 18	80.983562
18 or over but less than 19	79.471233
19 or over but less than 26	77.487671

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
26 or over but less than 27	73.958904
27 or over but less than 32	70.487671
32 or over but less than 33	67.463014
33 or over but less than 36	63.991781
36 or over but less than 37	57.942466
37 or over but less than 39	51.991781
39 or over but less than 40	44.934247
40 or over but less than 41	37.495890
41 or over but less than 42	31.446575
42 or over but less than 43	19.446575
43 or over but less than 44	12.893151
44 or over but less than 45	6.446575
45 or over	0

(c) *Surcharge period.* For purposes of this section the term "surcharge period" means the period beginning January 1, 1968, and ending June 30, 1970.

(d) *Illustration of principles.* The application of the rules set forth in paragraphs (a), (b), and (c) of this section may be illustrated by the following example. It is assumed that all computations are carried to sufficient accuracy:

Example. (a) M, a domestic corporation, and A, its controlled corporation (the one class of stock of which is wholly owned by M), both have a taxable year beginning December 1, 1969, and ending November 30, 1970. For such taxable year M makes a first-tier election with respect to A corporation. The effective foreign tax rate for such year is 30 percent.

(b) Under section 963(b) and paragraph (b) of this section the surcharge period ends June 30, 1970. Therefore, of the 365 days in the taxable year, 153 days are not within the surcharge period. Of the remaining 212 days, 31 are within the surcharge period and before January 1, 1970 and 181 days are within the surcharge period and after December 31, 1969. If section 963(b)(1) were applicable to the entire taxable year, the required minimum distribution of earnings and profits would be 75 percent. If section 963(b)(2) were applicable to the entire taxable year, the required minimum distribution would be 72 percent. If section 963(b)(3) were applicable to the entire taxable year, the required minimum distribution would be 69 percent.

(c) Under section 963(b) and this section the required minimum distribution of earnings and profits is 71 percent, computed as follows:

$$(75\% \times 31 \div 365) + (72\% \times 181 \div 365) + (69\% \times 153 \div 365) = 71\%.$$

[T.D. 7100, 36 FR 5336, Mar. 20, 1971]

§ 1.964–1 Determination of the earnings and profits of a foreign corporation.

(a) *In general.* For purposes of sections 951 through 964, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall, except as provided in paragraph (f) of this section, be computed substantially as if such corporation were a domestic corporation by—

(1) Preparing a profit and loss statement with respect to such year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders;

(2) Making the adjustments necessary to conform such statement to the accounting principles described in paragraph (b) of this section;

(3) Making the further adjustments necessary to conform such statement to the tax accounting standards described in paragraph (c) of this section;

(4) Translating the amounts shown on such adjusted statement into United States dollars in accordance with paragraph (d) of this section, and

(5) Adjusting the amount of profit or loss shown on such translated and adjusted statement in accordance with paragraph (e) of this section to reflect any exchange gain or loss determined thereunder.

The computation described in the preceding sentence may be made by following the procedures described in subparagraphs (1) through (5) of this paragraph in an order other than the one listed, as long as the result so obtained would be the same. No adjustment shall be required under subparagraph (2) or (3) of this paragraph unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature. For the treatment of earnings and profits whose distribution is prevented by restrictions and limitations imposed by a foreign government, see section 964(b) and the regulations thereunder.

(b) *Accounting adjustments*—(1) *In general.* The accounting principles to be applied in making the adjustments required by paragraph (a)(2) of this section shall be those accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates, including the following:

(i) *Clear reflection of income.* Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) *Physical assets, depreciation, etc.* All physical assets (as defined in paragraph (e)(5)(ii) of this section), including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost. For special rules for determining historical cost where assets are acquired during a taxable year beginning before January 1, 1950, or a majority interest in the foreign corporation is acquired after December 31, 1949, but before October 27, 1964, see subparagraph (2) of this paragraph.

(iii) *Valuation of assets and liabilities.* Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section. For example, an adjustment will be required where inventory is written down below market value. For the definition of market value, see paragraph (a) of § 1.471-4.

(iv) *Income equalization.* Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section.

(v) *Foreign currency.* If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, such translation shall be made in a manner substantially similar to that prescribed by paragraph (d) of this section for the translation of foreign currency amounts into United States dollars.

(2) *Historical cost.* For purposes of this section, the historical cost of an asset acquired by the foreign corporation during a taxable year beginning before January 1, 1963, shall be determined, if it is so elected by or on behalf of such corporation—

(i) In the event that the foreign corporation became a majority owned subsidiary of a United States person (within the meaning of section 7701(a)(30)) after December 31, 1949, but before October 27, 1964, and the asset was held by such foreign corporation at that time, as though the asset was purchased on the date during such period the foreign corporation first became a majority owned subsidiary at a price equal to its then fair market value, or

(ii) In the event that subdivision (i) of this subparagraph is inapplicable but the asset was acquired by the foreign corporation during a taxable year beginning before January 1, 1950, as though the asset were purchased on the first day of the first taxable year of the foreign corporation beginning after December 31, 1949, at a price equal to the undepreciated cost (cost or other basis minus book depreciation) of that asset as of that date as shown on the books of account of such corporation regularly maintained for the purpose of accounting to its shareholders.

For purposes of this subparagraph, a foreign corporation shall be considered a majority owned subsidiary of a United States person if, taking into account only stock acquired by purchase (as defined in section 334(b)(3)), the United States person owns (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. The election under this subparagraph shall be made for the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957) or for which it is included in a chain or group under section 963(c) (2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) or has a deficit in earnings and profits sought to be taken into account under section 952(d). Once made, such an election shall be irrevocable. For the time and manner in which an election may be made on behalf of a foreign corporation, see paragraph (c)(3) of this section.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Corporation M is a controlled foreign corporation which regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices prevalent in country X, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects an allocation to an arbitrary reserve out of current income and depreciation allowances based on replacement values which are greater than historical cost. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices, will have to be eliminated from the statement, an increase in the amount of profit (or a decrease in the amount of loss) thereby resulting.

Example (2). Corporation N is a foreign corporation which is not a controlled foreign corporation but which is included in a chain, for minimum distribution purposes, under section 963(c)(2)(B). Corporation N regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices of country Y, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects the inclusion in income of stock dividends and of corporate distributions representing a return of capital. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices will have to be eliminated from the statement, a decrease in the amount of profit (or increase in the amount of loss) thereby resulting.

(c) *Tax adjustments*—(1) *In general.* The tax accounting standards to be applied in making the adjustments required by paragraph (a)(3) of this section shall be the following:

(i) *Accounting methods.* The method of accounting shall reflect the provisions of section 446 and the regulations thereunder.

(ii) *Inventories.* Inventories shall be taken into account in accordance with the provisions of sections 471 and 472 and the regulations thereunder.

(iii) *Depreciation.* Depreciation shall be computed as follows:

(*a*) For any taxable year beginning before July 1, 1972; depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(*b*) If, for any taxable year beginning after June 30, 1972, 20 percent or more of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with the provisions of § 1.312-15.

(*c*) If, for any taxable year beginning after June 30, 1972, less than 20 percent of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(iv) *Elections.* Effect shall be given to any election made in accordance with an applicable provision of the

Code and the regulations thereunder and these regulations.

Except as provided in subparagraphs (2) and (3) of this paragraph, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting must be satisfied by or on behalf of the foreign corporation just as though it were a domestic corporation if such election or such adoption or change of method is to be taken into account in the computation of its earnings and profits.

(2) *Adoption of method.* For the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957) or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) or has a deficit in earnings and profits sought to be taken into account under section 952(d), there may be adopted or made by such corporation or on its behalf any method of accounting or election allowable under this section notwithstanding that, in previous years, its earnings and profits were computed, or its books or financial statements prepared, on a different basis and notwithstanding that such election is required by the Code or regulations to be made in a prior taxable year. For purposes of determining the amount of a deficit in earnings and profits taken into account pursuant to section 952(c)(1)(B), if a different basis is used in previous years, ratable adjustments shall be made in the earnings and profits attributable to such previous years to prevent any duplication or omission of amounts that would otherwise result from the adoption of such method or the making of such election. See subparagraph (3) of this paragraph for the manner in which a method of accounting or an election may be adopted or made on behalf of the foreign corporation.

(3) *Action on behalf of corporation*—(i) *In general.* An election shall be deemed made, or an adoption or change in method of accounting deemed effectuated, on behalf of the foreign corporation only if its controlling United States shareholders (as defined in subparagraph (5) of this paragraph)—

(*a*) Satisfy for such corporation any requirements imposed by the Code or applicable regulations with respect to such election or such adoption or change in method, such as the filing of forms, the execution of consents, securing the permission of the Commissioner, or maintaining books and records in a particular manner,

(*b*) File the written statement described in subdivision (ii) of this subparagraph at the time and in the manner prescribed therein, and

(*c*) Provide the written notice required by subdivision (iii) of this subparagraph at the time and in the manner prescribed therein.

For purposes of the preceding sentence, the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling United States shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations thereunder in that manner. Any election required to be made or information required to be filed with a tax return shall be deemed made or furnished on behalf of the foreign corporation if its controlling United States shareholders file the written statement described in subdivision (ii) of this subparagraph with respect to such election within the period specified therein. For a special rule postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant, see subparagraph (6) of this paragraph.

(ii) *Written statement.* The written statement required by subdivision (i) of this subparagraph shall be jointly executed by the controlling United States shareholders, shall be filed with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania 19155, within 180 days after the close of the taxable year of the foreign corporation with respect to which the election is made or the adoption or change of method effected, or before May 1, 1965, whichever is later, and shall set forth the name and country of organization of the foreign corporation, the names, addresses, and stock interests of the controlling United States shareholders, the nature of the action taken, the names and addresses of all other United States shareholders notified of the election or adoption or change of method, and such other information as the Commissioner may by forms require.

(iii) *Notice.* Prior to the filing of the written statement described in subdivision (ii) of this subparagraph, the controlling United States shareholders shall provide written notice of the election made or the adoption or change of method effected to all other persons known by them to be United States shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice shall set forth the name and country of organization of the foreign corporation, the names, addresses, and stock interests of the controlling United States shareholders, the nature of the action taken, and such other information as the Commissioner may by forms require. However, the failure of the controlling United States shareholders to provide such notice to a person required to be notified thereunder shall not invalidate the election made or the adoption or change of method effected, if it is established to the satisfaction of the Commissioner that reasonable cause existed for such failure.

(4) *Effect of action by controlling United States shareholders.* Any action taken by the controlling United States shareholders on behalf of the foreign corporation pursuant to subparagraph (3) of this paragraph shall be reflected in the computation of the earnings and profits of such corporation under this section to the extent that it bears upon the tax liability of a United States shareholder who either—

(i) Was a controlling United States shareholder with respect to the action taken;

(ii) Received the written notice provided by subparagraph (3)(iii) of this paragraph;

(iii) Failed to file any of the returns required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d); or

(iv) Was notified by the Director of the Philadelphia Service Center of the action taken—

(*a*) Within 61 days after the last day (including extensions of time) prescribed with respect to the taxable year of the foreign corporation by subparagraph (3)(ii) of this paragraph for filing the written statement described in such subparagraph, or

(*b*) Within 180 days after the close of the first taxable year in which such shareholder becomes a United States shareholder, whichever is later.

To the extent that the computation of the earnings and profits of the foreign corporation bears upon the tax liability of any United States shareholder other than those enumerated in the preceding sentence, the computation shall reflect the action taken only if such shareholder assents to such treatment. Such assent may be given at any time, but not later than 90 days after the shareholder is first apprised of such action by the Director of the Philadelphia Service Center. The shareholder shall signify his assent by filing a written statement with the Director of the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania, 19155, setting forth the name and country of organization of the foreign corporation, his own name, address, and stock interest in the corporation, the nature of the action being assented to, and such other information as the Commissioner may by forms require.

(5) *Controlling United States shareholders.* For purposes of this paragraph the controlling United States shareholders of a foreign corporation shall be those United States shareholders (as defined in section 951(b)), who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote and who undertake to act on its behalf. In the event that the foreign corporation is not a controlled foreign corporation but is included in a chain or group under section 963(c) (2)(B) or (3)(B), the controlling United States

shareholder with respect to such foreign corporation shall be deemed to be the domestic corporation which elects to receive the minimum distribution from such chain or group. In the event that the foreign corporation is neither a controlled foreign corporation nor included in a chain or group under section 963(c) (2)(B) or (3)(B) but has a deficit in earnings and profits sought to be taken into account under section 952(d), the controlling United States shareholder with respect to such foreign corporation shall be the shareholder seeking to take such deficit into account. In the event that the foreign corporation is a controlled foreign corporation but the United States shareholders (as defined in section 951(b)) do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote, the controlling United States shareholders of the foreign corporation shall be all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation.

(6) *Action not required until significant.* Notwithstanding any other provision of this paragraph, action by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) to make an election or to adopt a method of accounting shall not be required until 180 days after the close of the first taxable year for which—

(i) An amount is includible in gross income with respect to such corporation under section 951(a);

(ii) It is sought to be established that such corporation is a less developed country corporation (within the meaning of section 955(c));

(iii) An amount is excluded from subpart F income (within the meaning of section 952) by section 952(c), section 952(d), or section 970(a); or

(iv) Such corporation is the subject of an election to secure an exclusion under section 963 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975).

In the event that action by or on behalf of the foreign corporation is not undertaken by the time specified in the preceding sentence and such failure is shown to the satisfaction of the Commissioner to be due to inadvertence or a reasonable cause, such action may be undertaken during any period of at least 30 days occurring after such showing is made which the Commissioner may specify as appropriate for this purpose. Where the action necessary to make an election or to adopt a method of accounting is undertaken by or on behalf of the foreign corporation in accordance with this subparagraph, such election shall be deemed to have been made, or such adoption of accounting method effected, for the first taxable year of the foreign corporation beginning after December 31, 1962, in which such corporation is a controlled foreign corporation (within the meaning of section 957) or for which it is included in a chain or group under section 963(c) (2)(B) or (3)(B) (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) or has a deficit in earnings and profits sought to be taken into account under section 952(d). For special rules for computing earnings and profits for purposes of section 1248 or income for purposes of applying an exclusion set forth in section 954(b) where the taxable year of the foreign corporation occurs prior to the making of elections or the adoption of methods of accounting under this subparagraph, see the regulations under section 952 and section 1248.

(7) *Revocation of election.* Notwithstanding any other provision of this section, any election made by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) may be modified or revoked by or on behalf of such corporation for the taxable year for which made whenever the consent of the Commissioner is secured for such modification or revocation, even though such election would be irrevocable but for this subparagraph.

(8) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). X Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by taking inventoriable items into account under the "first-in, first-out" method. A, B, and C, the United States shareholders of X Corporation, own 45 percent, 30 percent, and 25 percent of its voting stock, respectively. For the first taxable year of X Corporation beginning after December 31, 1962, B and C adopt on its behalf the "last-in, first-out" inventory method, notifying A of the action taken. Even though A may object to such action, adjustments must be made to reflect the use of the LIFO method of inventorying in the computation of the earnings and profits of X Corporation with respect to him as well as with respect to B and C.

Example (2). Y Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by employing the straight-line method of depreciation. D and E, the United States shareholders of Y Corporation, own 51 percent and 10 percent of its voting stock, respectively. For the first taxable year of Y Corporation beginning after December 31, 1962, D adopts on its behalf the declining balance method of depreciation. However, not knowing that E is a United States shareholder of the company, D fails to provide him with notice of the action taken. Assuming that E has filed the return required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d), adjustments in the computation of earnings and profits will not be required with respect to him unless the Director of International Operations notifies him of the action taken within 240 days after the close of Y's taxable year. If notice is not provided to E within this period, he will not be compelled to make the adjustments. At his option, however, he may accept the action taken by assenting thereto not later than 90 days after he is first apprised of such action by the Director of International Operations.

(d) *Translation into United States dollars*—(1) *In general*—(i) *General rule.* Except as provided in subdivisions (ii), (iii), and (iv) of this subparagraph, the amounts to be shown on the profit and loss statement, adjusted pursuant to paragraphs (b) and (c) of this section, shall be translated into United States dollars (as required by paragraph (a)(4) of this section) at the appropriate exchange rate for the translation period (as defined in subparagraph (6) of this paragraph) to which they relate.

(ii) *Cost of goods sold.* Amounts representing items of inventory reflected in the cost of goods sold shall be translated—

(*a*) To the extent that such amounts represent items included in the opening inventory balance, so as to obtain the same amount of United States dollars which represented (after translation and adjustment) such items in the closing inventory balance for the preceding taxable year,

(*b*) To the extent that such amounts represent items purchased or otherwise first included in inventory during the taxable year, at the appropriate exchange rate for the translation period in which the historical cost of such items was incurred, and

(*c*) To the extent that such amounts represent items included in the closing inventory balance, at the appropriate exchange rate for the translation period in which the historical cost of such items was incurred, except that, if such amounts are written down to market value, such market value shall be determined at the year-end rate. Notwithstanding the preceding sentence, amounts representing items of inventory included in the closing inventory balance may be translated at the year-end rate even though not written down to market value; however, once such a rate is employed under those circumstances, translation may not be made for subsequent taxable years at the appropriate exchange rate for the translation period in which the historical cost of the items of inventory was incurred unless the permission of the Commissioner is secured.

(iii) *Depreciation, depletion, and amortization.* Amounts representing allowances for depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have been incurred. For purposes of this subdivision, if the historical cost of an asset is determined under paragraph (b)(2) of this section, such cost shall be deemed to have been incurred on the date the asset is considered to have been purchased under that paragraph.

(iv) *Prepaid expenses or income.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated at the appropriate exchange rate for the translation period during which they were paid or received. Notwithstanding the preceding sentence, amounts representing such prepaid income or expenses may be translated at the year-end rate; however, once such a rate is employed, translation may not be made for subsequent taxable years at the appropriate exchange rate for the translation period during which such income or expenses were paid or received unless the permission of the Commissioner is secured.

(2) *Appropriate exchange rate*—(i) *In general.* Where the value of the foreign currency relative to the United States dollar does not fluctuate substantially during a translation period, a single exchange rate shall be appropriate for all amounts representing classes of items which relate to such period, such rate to be a simple average determined by dividing the sum of the closing rates for each of the calendar months ending with or within such period by the number of such months. On the other hand, where the value of the foreign currency relative to the United States dollar does fluctuate substantially during a translation period, the exchange rate appropriate to an amount representing a class of items which relates to such period shall be either (*a*) a simple average determined in accordance with the preceding sentence, or (*b*) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within such period, depending upon which average would produce a result more representative of that which would have been obtained by translating the individual transactions reflected by that amount at the closing rate for the month to which each such transaction relates. Whether the value of the foreign currency relative to the United States dollar fluctuates substantially during the translation period is a question of fact, depending upon, among other things, the extent to which the volume of transactions varies from month to month. In general, however, the degree of fluctuation will be considered substantial if the closing rate for any calendar month ending with or within the translation period varies by more than 10 percent from the closing rate for any preceding calendar month ending within that period.

(ii) *Monthly rate.* Notwithstanding subdivision (i) of this subparagraph, if it is so elected by or on behalf of the foreign corporation, and if the closing rate for any calendar month ending with or within a translation period does not vary by more than 3 percent from the closing rate for any preceding calendar month ending within that period, the appropriate exchange rate for amounts representing all classes of items relating to such period shall be any exchange rate which is designated in the election and which does not vary by more than 3 percent from the closing rate for any calendar month ending with or within such period. An election under this subdivision may be made with respect to any translation period of any taxable year of the foreign corporation beginning after December 31, 1962. Such election shall be effective only with respect to the translation period for which it is made, and once made shall be irrevocable with respect to that period. See paragraph (c)(3) of this section for the time and manner in which an election may be made on behalf of the foreign corporation.

(iii) *Class of items.* For purposes of this subparagraph, the term "class of items" means any category which is reflected separately on books of account or financial statements. For example, sales is a class of items which is reflected separately on the profit and loss statement, and accounts receivable is a class of items which is reflected separately on the balance sheet.

(3) *Closing rate.* The closing rate for any calendar month shall be the exchange rate on the last day of that month determined by reference to a qualified source of exchange rates within the meaning of subparagraph (5) of this paragraph.

(4) *Year-end rate.* The year-end rate shall be the closing rate for the last calendar month of the taxable year.

(5) *Qualified source of exchange rates.* A qualified source of exchange rates shall be any source which is demonstrated to the satisfaction of the district director to reflect actual transactions conducted in a free market and involving representative amounts. In

the absence of such a demonstration, the exchange rates taken into account in the computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issue of "International Financial Statistics" or a successor publication of the International Monetary Fund, or such other source of exchange rates reflecting actual transactions conducted in a free market and involving representative amounts as the Commissioner may designate as appropriate for this purpose.

(6) *Translation period*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, the translation period shall be a taxable year.

(ii) *Currency fluctuations.* If it is so elected by or on behalf of the foreign corporation, the taxable year shall be divided into groups consisting of a calendar month or consecutive calendar months as specified in the election, each such group constituting a separate translation period. Where the value of the foreign currency relative to the United States dollar fluctuates substantially during the taxable year, the use of the weighted average referred to in subparagraph (2)(i) of this paragraph ordinarily may be avoided by dividing the taxable year into translation periods so that the first translation period begins with the first day of such year and each subsequent translation period begins with the first day of the first calendar month thereafter ending with or within such year for which the closing rate varies by more than 10 percent from the closing rate for any month in the preceding translation period. An election under this subdivision may be made with respect to any taxable year of the foreign corporation beginning after December 31, 1962. Such election shall be effective only with respect to the taxable year for which it is made, and once made shall be irrevocable with respect to such year. For the time and manner in which an election may be made on behalf of the foreign corporation, see paragraph (c)(3) of this section.

(7) *Actual transactions.* Notwithstanding any other provisions of this paragraph—

(i) *Dollar transactions.* Any transaction involving the payment or receipt of United States dollars shall be reflected in the profit and loss statement by the amount of United States dollars involved in such transaction.

(ii) *Conversion transactions.* Any transaction involving the conversion of a foreign currency into United States dollars, or the conversion of United States dollars into a foreign currency, shall be reflected in the profit and loss statement by an amount expressed in United States dollars and determined by translation at the exchange rate at which conversion was effected if the foreign corporation knows, or reasonably should know, that exchange rate.

(iii) *Daily rate.* Any transaction other than one described in subdivision (i) or (ii) may be translated into United States dollars at the exchange rate for the day on which that transaction occurred, such rate to be determined by reference to a qualified source of exchange rates within the meaning of subparagraph (5) of this paragraph.

No transaction shall be required to be taken into account under subdivision (i) or (ii) unless the United States dollars involved are material in amount.

(8) *Other methods.* Notwithstanding the other provisions of this paragraph, translation into United States dollars may be made in accordance with a system or method not otherwise described in this paragraph, provided that such system or method (i) was employed by the corporation for purposes of accounting to its shareholders prior to January 1, 1963, and (ii) is shown to the satisfaction of the Commissioner to clearly reflect the earnings and profits of the corporation.

(9) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation, a controlled foreign corporation organized on January 1, 1963, employs the calendar year as its taxable year and maintains its books of account in abbas, the currency of the country in which it operates. During 1963 M Corporation's monthly sales amounted to 100,000 abbas per month, its total payroll and other expenses for the year amounted to 180,000 abbas, and its total inventory purchases amounted to 1,050,000 abbas. Also during 1963, M Corporation purchased depreciable assets for 1,000,000 abbas. The value of the abba relative to the United States dollar fluctuated only slightly in 1963; the monthly closing rate moved between 19.8 abbas and 20.2 abbas per United States dollar and stood at 19.9 abbas per United States dollar for most of the year and at yearend. An election under subparagraph (2)(ii) of this paragraph is made on behalf of M Corporation to use the par rate of 20 abbas per United States dollar as the exchange rate appropriate for 1963. Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph, M Corporation's adjusted profit and loss statement for 1963 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales	1,200,000	20:1	60,000
Cost of goods sold:			
Purchases	1,050,000	20:1	52,500
Less: Closing inventory	(350,000)	20:1	(17,500)
	700,000		35,000
Wages and other expenses	180,000	20:1	9,000
Depreciation	200,000	20:1	10,000
Total costs and expenses	1,080,000		54,000
Operating profit	120,000		6,000

Example (2). The facts are the same as in example (1) and in addition during 1964 M Corporation had annual sales of 1,470,000 abbas, annual wages and other expenses of 252,000 abbas, and inventory purchases of 910,000 abbas. Also during 1964, M Corporation purchased additional depreciable as sets for 430,000 abbas, the bulk of such purchases being made in the last half of the year. The value of the abba relative to the United States dollar gradually declined in 1964, the monthly closing rate moving from 19.9 abbas per United States dollar down to 22 abbas per United States dollar. For most classes of items, the appropriate exchange rate is a simple average of monthly closing rates or 21 abbas per United States dollar. However, since the bulk of the depreciable asset purchases were made in the last half of the year, the rate representative of those transactions is a weighted average of 21.5 abbas per United States dollar. Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph and that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1964 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales	1,470,000	21:1	70,000
Cost of goods sold:			
Opening inventory	350,000	20:1	17,500
Purchases	910,000	21:1	43,333
Less: Closing inventory	(418,000)	21:1	(19,905)
	842,000		40,928
Wages and other expenses	252,000	21:1	12,000
Depreciation:			
1963 assets	150,000	20:1	7,500
1964 assets	86,000	21.5:1	4,000
Total costs and expenses	1,330,000		64,428
Operating profit	140,000		5,572

Example (3). The facts are the same as in examples (1) and (2) except that the 1964 sales of M Corporation amounted to 1,260,000 abbas plus $10,500 in United States dollars. Assuming that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1964 would be translated as follows:

	Local currency	Exchange rate	U.S. dollars
Sales—Abbas	1,260,000	21:1	60,000
Sales—U.S. dollars	215,250	(1)	10,500
Total sales	1,475,250		70,500
Cost of goods sold:			
Opening inventory	350,000	20:1	17,500
Purchases	910,000	21:1	43,333
Less: Closing inventory	(418,000)	21:1	19,905
	842,000		40,928
Wages and other expenses	252,000	21:1	12,000
Depreciation:			
1963 assets	150,000	20:1	7,500
1964 assets	86,000	21.5:1	4,000
Total costs and expenses	1,330,000		64,428
Operating profit	145,250		6,072

[1] Transaction.

Example (4). The facts are the same as in examples (1) and (2). M Corporation continues to operate during 1965 and the value of the abba relative to the United States dollar declines materially during that year; the monthly closing rate drops from 22 abbas per United States dollar to 26 abbas per United States dollar, a decrease of more than 10 percent. An election under subparagraph (6)(ii) of this paragraph is made on behalf of M Corporation to divide the year into translation periods, the applicable periods being January 1 through July 31 and August 1 through December 31. For most classes of items, the appropriate exchange rate for each of these translation periods is a simple average of monthly closing rates, or 23 abbas and 25 abbas per United States dollar, respectively. However, all of the depreciable asset purchases were made at the end of the first translation period—January 1 through July 31—and, therefore, the rate representative of those transactions is a weighted average of 24 abbas per United States dollar. The classes of items reflecting M Corporation's 1965 financial transactions and the representative rates of exchange for such classes of items are as follows:

	Local currency	Exchange rate
Sales:		
Jan. 1–July 31	1,000,000	23:1
Aug. 1–Dec. 31	500,000	25:1
Inventory Purchases:		
Jan. 1–July 31	559,000	23:1
Aug. 1–Dec. 31	361,000	25:1
Expenses:		
Jan. 1–July 31	115,000	23:1
Aug. 1–Dec. 31	145,000	25:1
Fixed asset purchases	216,000	24:1
Closing inventory	430,000	(1)

[1] Historical.

Assuming that M Corporation uses the first-in, first-out method of inventory valuation, the closing inventory is assumed in normal circumstances to consist of purchases made during the most recent translation period as follows:

	Local currency	Exchange rate	U.S. dollars
All of the August-December purchases	361,000	25:1	14,440
Balance from January-July purchases	69,000	23:1	3,000
Total closing inventory	430,000		17,440

Assuming that none of the amounts shown therein reflects a transaction described in subparagraph (7) of this paragraph, and that closing inventory is translated at historical rates, M Corporation's adjusted profit and loss statement for 1965 would be translated into United States dollars as follows:

	Local currency	Exchange rate	U.S. dollars
Sales:			
Jan. 1–July 31	1,000,000	23:1	43,478
Aug. 1–Dec. 31	500,000	25:1	20,000
	1,500,000		63,478
Cost of goods sold:			
Opening inventory purchases	418,000	21:1	19,905
Jan. 1–July 31	559,000	23:1	24,304
Aug. 1–Dec. 31	361,000	25:1	14,440
Less: Closing inventory	(430,000)	(1)	(17,440)
	908,000		41,209
Wages and other expenses:			
Jan. 1–July 31	115,000	23:1	5,000
Aug. 1–Dec. 31	145,000	25:1	5,800
Depreciation:			
1963 assets	120,000	20:1	6,000
1964 assets	64,500	21.5:1	3,000
1965 assets	43,200	24:1	1,800
Total costs and expenses	1,395,700		62,809
Operating profit	104,300		669

[1] Historical.

(e) *Exchange gain or loss*—(1) *In general.* The exchange gain or loss determined in accordance with subparagraph (2) of this paragraph shall be applied against and reduce, or applied to and increase, as the case may be, the amount of profit or loss shown on the profit and loss statement prepared pursuant to paragraph (a)(1) of this section, as adjusted and translated pursuant to paragraph (a) (2), (3), and (4) of this section. For the manner in which the exchange gain or loss is to be allocated to or applied against subpart F income, see section 952 and the regulations thereunder.

(2) *Determination of exchange gain or loss.* The exchange gain (or loss) for the taxable year shall be the amount which equals—

(i) The retained earnings for the taxable year as determined under subparagraph (3) of this paragraph, plus

(ii) The amount of any distributions made during the taxable year translated at the exchange rate appropriate to the translation period during which such distributions were made (or taken into account) in accordance with paragraph (d)(7) of this section, if applicable, minus

(iii) The amount representing retained earnings for the preceding taxable year as determined under subparagraph (3) of this paragraph, minus

(iv) The amount of profit (or plus the amount of any loss) shown on the profit and loss statement for the taxable year prepared pursuant to paragraph (a)(1) of this section and adjusted and translated pursuant to paragraph (a) (2), (3), and (4) of this section.

(3) *Retained earnings.* The retained earnings for any taxable year shall be determined by first—

(i) Preparing a balance sheet as of the end of such year from the books of account regularly maintained by the foreign corporation for the purpose of accounting to its shareholders;

(ii) Making the adjustments necessary to conform such balance sheet to the accounting principles described in paragraph (b) of this section;

(iii) Making the further adjustments necessary to conform such balance sheet to the tax accounting standards described in paragraph (c) of this section; and

(iv) Translating the amounts shown on the balance sheet (other than amounts representing retained earnings) into United States dollars in accordance with subparagraph (4) of this paragraph.

The retained earnings shall be an amount equal to the excess of the aggregate amount representing assets on the balance sheet (as adjusted and translated under this subparagraph) over the aggregate amount representing liabilities, reserves (other than reserves out of current or accumulated earnings), and paid- in capital on the balance sheet (as adjusted and translated under this subparagraph).

(4) *Translation of balance sheet.* Amounts shown on the balance sheet as adjusted pursuant to subparagraph (3) (ii) and (iii) of this paragraph (other than amounts representing retained earnings) shall be translated into United States dollars as follows:

(i) *Financial assets.* Amounts representing financial assets shall be translated at the year-end rate.

(ii) *Physical assets.* Amounts representing physical assets (other than inventory) shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset was incurred or is deemed to have been incurred. For special rules for determining date on which the historical cost of certain assets acquired during taxable years beginning before January 1, 1950, or owned at the time a majority interest in the corporation was acquired after December 31, 1949, but before October 27, 1964, is deemed to have been incurred, see paragraph (b)(2) of this section.

(iii) *Depreciation and similar reserves.* Amounts representing depreciation, depletion, and amortization reserves shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have been incurred.

(iv) *Inventory.* Amounts representing items of inventory included in the closing inventory balance shall be translated in accordance with paragraph (d)(1)(ii) of this section.

(v) *Bad debt reserves.* Amounts representing bad debts reserves shall be translated at the year-end rate.

(vi) *Prepaid income or expense.* Amounts representing expenses or income paid or received in a prior taxable year shall be translated in accordance with paragraph (d)(1)(iv) of this section.

(vii) *Short-term liabilities.* Amounts representing short-term liabilities shall be translated at the year-end rate.

(viii) *Long-term liabilities.* Amounts representing long-term liabilities shall be translated at the appropriate exchange rate for the translation period in which such liabilities were incurred.

(ix) *Paid-in capital.* Amounts representing paid-in capital shall be translated at the appropriate exchange rate for the translation period in which such capital was paid in.

Notwithstanding any other provisions of this subparagraph, where the amount representing an item shown on the balance sheet reflects a transaction described in paragraph (d)(7) of this section, such transaction shall be taken into account in accordance with that paragraph.

(5) *Definitions.* For purposes of this paragraph—

(i) *Financial assets.* A financial asset shall be any asset reflecting a fixed amount of foreign currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities (within the meaning of section 1236(c)) shall be considered physical assets if they have been or are reasonably expected to be held for at least six months; if not they shall be considered financial assets whether or not they reflect a fixed amount of foreign currency. Moreover, advances on open account to any corporation in which the foreign corporation and any related persons (within the meaning of section 954(d)(3) and the regulations thereunder) with respect thereto own at least 10 percent of the combined voting power of all classes of stock entitled to vote shall not be considered financial assets if such advances have remained open for more than one year.

(ii) *Physical assets.* A physical asset shall be any asset other than a financial asset and shall include goodwill, patents, and other intangibles.

(iii) *Short-term liabilities.* A short-term liability shall be any indebtedness of the foreign corporation which is due or overdue as of the date of the balance sheet or which will become due within 1 year thereafter.

(iv) *Long-term liabilities.* A long-term liability is any indebtedness of the foreign corporation other than a short-term liability.

For the definition of "appropriate exchange rate", "year-end rate", and "translation period", see paragraph (d) (2), (4), and (6), respectively, of this section.

(6) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). N Corporation is a controlled foreign corporation which uses the calendar year as its taxable year and which maintains its books in yuccas, the currency of the country in which it operates. For 1963, its operating profit is 140,000 yuccas or $55,720. At the end of the year, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	77,000	2.20:1	35,000
Accounts receivable	209,000	2.20:1	95,000
Inventory	418,000	(1)	199,050
Fixed assets	1,430,000	(1)	700,000
Less: Accumulated depreciation	(436,000)	(1)	(215,000)
Total assets	1,698,000		814,050
Current liabilities	338,000	2.20:1	153,640
Long-term liabilities	300,000	(1)	150,000
Paid-in capital	800,000	(1)	400,000
Retained earnings	260,000		110,410
Total liabilities and net worth	1,698,000		814,050

[1] Historical.

N Corporation's retained earnings for 1962 are determined on the basis of its balance sheet as of the end of that year, translated as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	70,000	2.00:1	35,000
Accounts receivable	180,000	2.00:1	90,000
Inventory	350,000	(1)	175,000
Fixed assets	1,000,000	(1)	500,000
Less: Accumulated depreciation	(200,000)	(1)	(100,000)
Total assets	1,400,000		700,000
Current liabilities	180,000	2.00:1	90,000
Long-term liabilities	300,000	(1)	150,000
Paid-in capital	800,000	(1)	400,000
Retained earnings	120,000		60,000
Total liabilities and net worth	1,400,000		700,000

[1] Historical.

The exchange gain or loss of N Corporation for 1963 may be computed as follows:

Retained earnings—1963		$110,410
Less:		
Retained earnings—1962	$60,000	
Operating profit—1963	55,720	115,720
Exchange loss		(5,310)

Example (2). Assume the same facts as in example (1). For 1964, N Corporation's operating profit is 104,300 yuccas or $15,740. It pays a dividend of 26,000 yuccas during a translation period when the appropriate exchange rate is 2.60 yuccas per United States dollar. At yearend, its balance sheet, as translated and adjusted pursuant to subparagraph (3) of this paragraph, is as follows:

	Local currency	Exchange rate	U.S. dollars
Cash	91,000	2.60:1	35,000
Accounts receivable	260,000	2.60:1	100,000
Inventory	430,000	(1)	174,400
Fixed assets	1,646,000	(1)	790,000
Less: Accumulated depreciation	(663,700)	(1)	(323,000)
Total assets	1,763,300		776,400
Current liabilities	325,000	2.60:1	125,000
Long-term liabilities	300,000	(1)	150,000
Paid-in capital	800,000	(1)	400,000
Retained earnings	338,300		101,400
Total liabilities and net worth	1,763,300		776,400

[1] Historical.

The exchange gain or loss of N Corporation for 1964 would be computed as follows:

Retained earnings—1964		$101,400
Add:		
Dividends—1964		10,000
Predistribution earnings		111,400
Less:		
Retained earnings—1963	$110,410	
Operating profit—1964	15,740	126,150
Exchange loss		(14,750)

(f) *Determination of earnings and profit as if a domestic corporation.* If the books of account regularly maintained by a foreign corporation for the purpose of accounting to its shareholders are kept in United States dollars and in accordance with accounting principles generally accepted in the United States, and if it is so elected by or on behalf of such corporation, the earnings and profits of the foreign corporation for a taxable year shall be determined in every respect as if it were a domestic corporation. Such election shall be effective only for the taxable year with respect to which the election is made. Once made, such election shall be irrevocable. See paragraph (d)(3) of this section for the time and manner in which an election may be made on behalf of a foreign corporation.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964; 29 FR 15204, Nov. 11, 1964, as amended by T.D. 6787, 29 FR 18502, Dec. 29, 1964; T.D. 6829, 30 FR 8044, June 23, 1965; T.D. 6995, 34 FR 832, Jan. 18, 1969; T.D. 7221, 37 FR 24747, Nov. 21, 1972; T.D. 7322, 39 FR 30931, Aug. 27, 1974; T.D. 7545, 43 FR 19652, May 8, 1978]

§ 1.964-2 Treatment of blocked earnings and profits.

(a) *General rule.* If, in accordance with paragraph (d) of this section, it is established to the satisfaction of the district director that any amount of the earnings and profits of a controlled foreign corporation for the taxable year (determined under § 1.964-1) was subject to a currency or other restriction or limitation imposed under the laws of any foreign country (within the meaning of paragraph (b) of this section) on its distribution to United States shareholders who own (within the meaning of section 958(a)) stock of such corporation, such amount shall not be included in earnings and profits for purposes of sections 952, 955, and 956 for such taxable year. For rules governing the treatment of amounts with respect to which such restriction or limitation is removed, see paragraph (c) of this section.

(b) *Rules of application.* For purposes of paragraph (a) of this section—

(1) *Period of restriction or limitation.* An amount of earnings and profits of a controlled foreign corporation for any taxable year shall not be included in earnings and profits for purposes of sections 952, 955, and 956 only if such amount of earnings and profits is subject to a currency or other restriction or limitation (within the meaning of subparagraph (2) of this paragraph) throughout the 150-day period beginning 90 days before the close of the taxable year and ending 60 days after the close of such taxable year.

(2) *Restriction or limitation defined.* Whether earnings and profits of a controlled foreign corporation are subject to a currency or other restriction or limitation imposed under the laws of a foreign country must be determined on the basis of all the facts and circumstances in each case. Generally, such a restriction or limitation must prevent—

(i) The ready conversion (directly or indirectly) of such currency into United States dollars, or into property of a type normally owned by such corporation in the operation of its business or other money which is readily convertible into United States dollars; or

(ii) The distribution of dividends by such corporation to its United States shareholders.

For purposes of this subparagraph, if a United States shareholder owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 80 percent or more of the total combined voting power of all classes of stock of a foreign corporation in a chain of ownership described in section 958(a), the distribution of dividends by such corporation to such shareholder will not be considered prevented solely by reason of the existence of a currency or other restriction or limitation at an intermediate tier in such chain if dividends may be distributed directly to such shareholders.

(3) *Foreign laws.* A currency or other restriction or limitation on the distribution of earnings and profits may be imposed in a foreign country by express statutory provisions, executive orders or decrees, rules or regulations of a governmental agency, court decisions, the actions of appropriate officials who are acting within the scope of their authority, or by any similar official action. A currency restriction will not be considered to exist unless export restrictions are also imposed which prevent the exportation of property of a type normally owned by the controlled foreign corporation in the operation of its business which could be readily converted into United States dollars.

(4) *Voluntary restriction or limitation.* A currency or other restriction or limitation arising from the voluntary act of the controlled foreign corporation or its United States shareholders during a taxable year beginning after December 31, 1962, will not be taken into account. For example, if a controlled foreign corporation—

(i) Issues a stock dividend which has the effect of capitalizing earnings and profits;

(ii) Elects to restrict its earnings and profits or to make certain investments as a means of avoiding current tax or securing a reduced rate of tax; or

(iii) Allocates earnings and profits to an optional or arbitrary reserve; such restriction is voluntary and will not be taken into account.

(5) *Treatment of earnings and profits in cases of certain mandatory reserves*—(i) *In general.* If a controlled foreign corporation is required under the laws of a foreign country to establish a reserve out of earnings and profits for the taxable year, such earnings and profits shall be considered subject to a restriction or limitation by reason of such requirement only to the extent that the amount required to be included in such reserve at the close of the taxable year exceeds the accumulated earnings and profits (determined in accordance with subdivision (ii) of this subparagraph) of such corporation at the close of the preceding taxable year.

(ii) *Determination of earnings and profits.* For purposes of determining the accumulated earnings and profits of a controlled foreign corporation under subdivision (i) of this subparagraph, such earnings and profits shall not include any amounts which are attributable to—

(*a*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder under section 951(a) and have not been distributed;

(*b*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such foreign corporation under section 551(b) and have not been distributed; or

(*c*) Amounts which become subject to a voluntary restriction or limitation (within the meaning of subparagraph (4) of this paragraph) during a taxable year beginning before January 1, 1963.

The rules of this subdivision apply only in determining the accumulated earnings and profits of a controlled foreign corporation for purposes of this subparagraph. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(6) *Exhaustion of procedures for distributing earnings and profits.* Earnings and profits of a controlled foreign corporation for a taxable year will not be considered subject to a currency or other restriction or limitation on their distribution unless the United States shareholders of such corporation demonstrate either that the available procedures for distributing such earnings and profits have been exhausted or that the use of such procedures will be futile. As a general rule, such procedures will be considered to have been exhausted if the foreign corporation applies for dollars (or foreign currency readily convertible into dollars) at the appropriate rate of exchange and complies with the applicable laws and regulations governing the acquisition and transfer of such currency including submission of the necessary documentation to the exchange authority. The fact that available procedures for distributing earnings and profits were exhausted without success with respect to a prior year is not, of itself, sufficient evidence that such procedures would not be successful with respect to the current taxable year.

(c) *Removal of restriction or limitation*—(1) *In general.* If, during any taxable year, a currency or other restriction or limitation (within the meaning of paragraph (b) of this section) imposed under the laws of a foreign country on the distribution of earnings and profits of a controlled foreign corporation to its United States shareholders is removed—

(i) *Treatment of deferred income.* Each United States shareholder of such corporation on the last day in such year that such corporation is a controlled foreign corporation shall include in his gross income for such taxable year the amounts attributable to such earnings and profits which would have been includible in his gross income under section 951(a) for prior taxable years but for the existence of the currency or other restriction or limitation except that the amounts included under this subdivision (i) shall not exceed his pro rata share of—

(*a*) The earnings and profits upon which the restriction was removed determined on the basis of his stock ownership on the last day of the immediately preceding taxable year, and

(*b*) The applicable limitations of paragraph (c) of § 1.952-1, paragraph (v)(2) of § 1.955-1, or paragraph (b) of § 1.956-1, determined as of the last day of the immediately preceding taxable year, taking into account the provisions of subdivision (ii) of this subparagraph.

(ii) *Treatment of earnings and profits.* For purposes of sections 952, 955, and 956, the earnings and profits which are no longer subject to a currency or other restriction or limitation shall be treated as included in the corporation's earnings and profits for the year in which such earnings and profits were derived.

Amounts with respect to which a currency or other restriction or limitation is removed shall be translated into United States dollars at the appropriate exchange rate for the translation period during which such currency or other restriction or limitation is removed. See paragraph (d) of § 1.964-1. Amounts with respect to which a currency or other restriction or limitation is removed shall not be taken into account in determining whether a deficiency distribution (within the meaning of § 1.963-6 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975)) is required to be made for the year in which such earnings and profits were derived.

(2) *Removal of restriction or limitation defined.* An amount of earnings and profits shall be considered no longer subject to a limitation or restriction if and to the extent that—

(i) Money or property in such foreign country is readily convertible into United States dollars, or into other money or property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars;

(ii) Notwithstanding the existence of any laws or regulations forbidding the exchange of money or property into United States dollars, conversion is actually made into United States dollars, or other money or property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars; or

(iii) A mandatory reserve requirement (described in paragraph (b)(5) of this section) is removed either by a change in law of the foreign country imposing such requirement or by an accumulation of earnings and profits not subject to such requirement.

(3) *Distribution in foreign country.* If, during any taxable year, earnings and profits previously subject to a currency or other restriction or limitation are distributed in a foreign country to one or more United States shareholders of a controlled foreign corporation directly, or indirectly through a chain of ownership described in section 958(a), such earnings and profits shall be considered no longer subject to a restriction or limitation. However, distributed amounts may be excluded from such shareholder's gross income for the taxable year of receipt if such shareholder elects a method of accounting under which the reporting of blocked foreign income is deferred until the income ceases to be blocked.

(4) *Source of distribution.* If, during any taxable year, earnings and profits previously subject to a currency or other restriction or limitation is distributed to one or more United States shareholders of a controlled foreign corporation directly, or indirectly through a chain of ownership described in section 958(a), the source of such distribution shall be determined in accordance with the rules of § 1.959-3.

(5) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

Example. (a) M, a United States person, owns all of the only class of stock of A Corporation, a foreign corporation incorporated under the laws of foreign country X on January 1, 1963. Both M and A Corporations use the calendar year as a taxable year and A Corporation is a controlled foreign corporation throughout the period here involved.

(b) During 1963, A Corporation derives income of $100,000 all of which is subpart F income and has earnings and profits of $100,000. Under the laws of X Country, currency cannot be exported without a license. During the last 90 days of 1963 and the first 60 days of 1964, A Corporation can obtain a license to distribute only an amount equivalent to $10,000. M must include $10,000 in his gross income for 1963 under section 951(a)(1)(A)(i) and $90,000 of A Corporation's earnings and profits for 1963 are not taken into account for purposes of sections 952, 955, and 956.

(c) During 1964, A Corporation has no income and no earnings and profits. On June 1, 1964, A Corporation converts an amount equivalent to $20,000 into property of a type normally owned by such corporation in the operation of its business which is readily convertible into United States dollars but does not distribute such amount. Corporation A must include $20,000 in its earnings and profits for 1963 for purposes of sections 952, 955, and 956. M must include $20,000 in his gross income for 1964.

(d) During 1965, A Corporation has no income and no earnings and profits. On December 15, 1965, A Corporation distributes an amount equivalent to $15,000 to M in X Country. Neither M nor A Corporation can obtain a license to export currency from X Country. In his return for the taxable year 1965, M elects a method of accounting under which the reporting of blocked foreign income is deferred until the income ceases to be blocked. Accordingly, M does not include the $15,000 in his gross income for 1965.

(e) During 1966, A Corporation has no income and no earnings and profits. On February 1, 1966, notwithstanding the laws and regulations of X Country which forbid the exchange of X Country's currency into United States dollars, M converts an amount equivalent to $15,000 into a currency which is readily convertible into United States dollars. Since the income has ceased to be blocked, M must include $15,000 in his gross income for 1966.

(d) *Manner of claiming existence of restriction or limitation on distribution of earnings and profits.* A United States shareholder claiming that an amount of the earnings and profits of a controlled foreign corporation for the taxable year was subject to a currency or other restriction or limitation imposed under the laws of a foreign country on its distribution shall file a statement with his return for the taxable year with or within which the taxable year of the foreign corporation ends which shall include—

(1) The name and address of the foreign corporation,

(2) A description of the classes of stock of the foreign corporation and a statement of the number of shares of each class owned (within the meaning of section 958(a)) or considered as owned (by applying the rules of own-

ership of section 958(b)) by the United States shareholder,

(3) A description of the currency or other restriction or limitation on the distribution of earnings and profits,

(4) The total earnings and profits of the foreign corporation for the taxable year (before any amount is excluded from earnings and profits under this section) and the United States shareholder's pro rata share of such total earnings and profits,

(5) The United States shareholder's pro rata share of the amount of earnings and profits subject to a restriction or limitation on distribution,

(6) The amounts which would be includible in the United States shareholder's gross income under section 951(a) but for the existence of the currency or other restriction or limitation,

(7) A description of the available procedures for distributing earnings and profits and a statement setting forth the steps taken to exhaust such procedures or a statement setting forth the reasons that the use of such procedures would be futile, and

(8) The amount of distributions made in a foreign country and a statement as to whether a method of accounting has been elected under which the reporting of blocked income is deferred until such income ceases to be blocked, including an identification of the taxable year and place of filing of such election.

In addition, such United States shareholder shall furnish to the district director such other information as he may require to verify the status of a currency or other restriction or limitation.

[T.D. 6892, 31 FR 11142, Aug. 23, 1966, as amended by T.D. 7545, 43 FR 19652, May 8, 1978]

§ 1.964-3 Records to be provided by United States shareholders.

(a) *Shareholder's responsibility for providing records.* For purposes of verifying his income tax liability in respect of amounts includible in income under section 951 for the taxable year of a controlled foreign corporation each United State shareholder (as defined in section 951(b)) who owns (within the meaning of section 958(a)) stock of such corporation shall, within a reasonable time after demand by the district director, provide the district director—

(1) Such permanent books of account or records as are sufficient to satisfy the requirements of section 6001 and section 964(c), or true copies thereof, as are reasonably demanded, and

(2) If such books or records are not maintained in the English language, either (i) an accurate English translation of such books or records or (ii) the services of a qualified interpreter satisfactory to the district director.

If such books or records are being used by another district director, the United States shareholder upon whom the district director has made a demand to provide such books or records shall file a statement of such fact with his district director, indicating the location of such books or records. For the length of time the United States shareholder of a controlled foreign corporation must cause such books or records as are under his control to be retained, see paragraph (e) of § 1.6001-1.

(b) *Records to be provided.* Except as otherwise provided in paragraph (c) of this section, the requirements of section 6001 and section 964(c) for record keeping shall be considered satisfied if the books or records produced are sufficient to verify for the taxable year—

(1) The subpart F income of the controlled foreign corporation and, if any part of such income is excluded from the income of the United States shareholder under section 963 or section 970(a), the application of such exclusion,

(2) The previously excluded subpart F income of such corporation withdrawn from investment in less developed countries,

(3) The previously excluded export trade income of such corporation withdrawn from investment, and

(4) The increase in earnings invested by such corporation in United States property.

(c) *Special rules.* Verification of the subpart F income of the controlled foreign corporation for the taxable year shall not be required if—

(1) It can be demonstrated to the satisfaction of the district director that—

(i) The locus and nature of such corporation's activities were such as to make it unlikely that the foreign base company income of such corporation (determined in accordance with paragraph (d)(3)(i) of § 1.954-1) exceeded 20 percent of its gross income (determined in accordance with paragraph (d)(3)(ii) of § 1.954-1) for the taxable year, and

(ii) If such corporation reinsures or issues insurance or annuity contracts in connection with United States risks, the 5-percent minimum premium requirement prescribed in paragraph (b) of § 1.953-1 has not been exceeded for the taxable year, or

(2) The United States shareholder's pro rata share of such subpart F income is excluded in full from his income under section 963 and the books or records verify the application of such exclusion.

[T.D. 6824, 30 FR 6480, May 11, 1965]

§ 1.964-4 Verification of certain classes of income.

(a) *In general.* The provisions of this section shall apply for purposes of determining when books or records are sufficient for purposes of § 1.964-3 to verify the classes of income described in such section.

(b) *Subpart F income.* Books or records sufficient to verify the subpart F income of a controlled foreign corporation must establish for the taxable year—

(1) Its gross income and deductions,

(2) The income derived from the insurance of United States risks (as provided in paragraph (c) of this section),

(3) The foreign base company income (as provided in paragraph (d) of this section), and

(4) In the case of a United States shareholder claiming the benefit of the exclusion provided in section 952(b) or the limitation provided in section 952(c)—

(i) The items of income excluded from subpart F income by paragraph (b) of § 1.952-1 as income derived from sources within the United States, the United States income tax incurred with respect thereto, and the deductions properly allocable thereto and connected therewith, and

(ii) The earnings and profits, or deficit in earnings and profits, of any foreign corporation necessary for the determinations provided in paragraphs (c) and (d) of § 1.952-1.

(c) *Income from insurance of United States risks.* Books or records sufficient to verify the income of a controlled foreign corporation from the insurance of United States risks must establish for the taxable year—

(1) That the 5-percent minimum premium requirement prescribed in paragraph (b) of § 1.953-1 has not been exceeded, or

(2) The taxable income, as determined under § 1.953-4 or § 1.953-5, which is attributable to the reinsuring or the issuing of any insurance or annuity contracts in connection with United States risks, as defined in § 1.953-2 or § 1.953-3.

(d) *Foreign base company income and exclusions therefrom.* Books or records sufficient to verify the income of a controlled foreign corporation which is foreign base company income must establish for the taxable year the following items:

(1) *Foreign personal holding company income.* The foreign personal holding company income to which section 954(c) and § 1.954-2 apply, for which purpose there must be established the gross income from—

(i) All rents and royalties,

(ii) Rents and royalties received in the active conduct of a trade or business from an unrelated person, as determined under section 954(c)(3)(A) and paragraph (d)(1) of § 1.954-2,

(iii) Rents and royalties received from a related person for the use of property in the country of incorporation of the controlled foreign corporation, as determined under section 954(c)(4)(C) and paragraph (e)(3) of § 1.954-2,

(iv) All dividends, interest, and except where the controlled foreign corporation is a regular dealer in stock or securities, all gains and losses from the sale or exchange of stock or securities,

(v) Dividends, interest, and gains from the sale or exchange of stock or securities, received in the conduct of a banking, financing, or insurance business from an unrelated person, as determined under section 954(c)(3)(B) and paragraph (d) (2) and (3) of § 1.954-2,

(vi) Dividends and interest received from a related corporation organized in the country of incorporation of the controlled foreign corporation, as determined under section 954(c)(4)(A) and paragraph (e)(1) of § 1.954-2,

(vii) Interest received in the conduct of a banking or other financing business from a related person, as determined under section 954(c)(4)(B) and paragraph (e)(2) of § 1.954-2,

(viii) All annuities,

(ix) All gains from commodities transactions described in section 553(a)(3),

(x) All income from estates and trusts described in section 553(a)(4),

(xi) All income from personal service contracts described in section 553(a)(5), and

(xii) All compensation for the use of corporate property by shareholders described in section 553(a)(6).

(2) *Foreign base company sales income.* The foreign base company sales income to which section 954(d) and § 1.954-3 apply, for which purpose there must be established the gross income from—

(i) All sales by the controlled foreign corporation of its personal property and all purchases or sales of personal property by such corporation on behalf of another person,

(ii) Purchases and/or sales of personal property in connection with transactions not involving related persons (as defined in paragraph (e)(2) of § 1.954-1),

(iii) Purchases and/or sales of personal property manufactured, produced, etc., in the country of incorporation of the controlled foreign corporation, as determined under paragraph (a)(2) of § 1.954-3,

(iv) Purchases and/or sales of personal property for use, etc., in the country of incorporation of the controlled foreign corporation, as determined under paragraph (a)(3) of § 1.954-3, and

(v) Sales of personal property manufactured or produced by the controlled foreign corporation, as determined under paragraph (a)(4) of § 1.954-3.

Where an item of income falls within more than one of subdivisions (ii) through (v) of this subparagraph, it shall be sufficient to establish that it falls within any one of them. If a branch or similar establishment is treated as a wholly owned subsidiary corporation through the application of section 954(d)(2) and paragraph (b) of § 1.954-3, the requirements of this subparagraph shall be satisfied separately for each branch or similar establishment so treated and for the remainder of the controlled foreign corporation.

(3) *Foreign base company services income.* The foreign base company services income to which section 954(e) and § 1.954-4 apply, for which purpose there must be established the gross income from—

(i) All services performed by the controlled foreign corporation,

(ii) Services other than those (as determined under paragraph (b) of § 1.954-4) performed for, or on behalf of, a related person,

(iii) Services performed in the country of incorporation of the controlled foreign corporation, as determined under paragraph (c) of § 1.954-4, and

(iv) Services performed in connection with the sale or exchange of, or with an offer or effort to sell or exchange, personal property manufactured, produced, etc., by the controlled foreign corporation, as determined under paragraph (d) of § 1.954-4.

Where an item of income falls within more than one of subdivisions (ii) through (iv) of this subparagraph, it shall be sufficient to establish that it falls within any one of them.

(4) *Qualified investments in less developed countries.* The gross income from dividends, interest, and gains received from qualified investments in less developed countries and excluded from foreign base company income under section 954(b)(1) and paragraph (b)(1) of § 1.954-1. If the controlled foreign corporation has a qualified investment in a less developed country corporation, it shall be necessary to establish, from the books or records of

the less developed country corporation, that such less developed country corporation meets the requirements of section 955(c) and § 1.955-5.

(5) *Income derived from aircraft or ships.* The gross income derived from aircraft or ships which is excluded from foreign base company income under section 954(b)(2) and paragraph (b)(2) of § 1.954-1.

(6) *Income on which taxes are not substantially reduced.* The gross income excluded from foreign base company income under section 954(b)(4) and paragraph (b) (3) or (4) of § 1.954-1 in the case of a controlled foreign corporation not availed of to substantially reduce income taxes, the income or similar taxes incurred with respect thereto, and all other factors necessary to verify the application of such exclusion.

(7) *Deductions.* The deductions allocable, under paragraph (c) of § 1.954-1, to each of the classes and subclasses of gross income described in subparagraphs (1) through (6) of this paragraph.

(e) *Exclusion under section 963.* Books or records sufficient to verify the application of the exclusion provided by section 963 with respect to the subpart F income for the taxable year of a controlled foreign corporation must establish that the conditions set forth in paragraph (a)(2) of § 1.963-1 have been met.

(f) *Exclusion under section 970(a).* Books or records sufficient to verify the application for the taxable year of the exclusion provided by section 970(a) in respect of export trade income which is foreign base company income must establish for such year—

(1) That the controlled foreign corporation is an export trade corporation, as defined in section 971(a) and paragraph (a) of § 1.971-1,

(2) The export trade income, as determined under section 971(b) and paragraph (b) of § 1.971-1, which constitutes foreign base company income,

(3) The export promotion expenses, as determined under section 971(d) and paragraph (d) of § 1.971-1, which are allocable to the excludable export trade income,

(4) The gross receipts, and the gross amount on which is computed compensation included in gross receipts, from property in respect of which the excludable export trade income is derived, as described in section 970(a)(1)(B) and paragraph (b)(2)(ii) of § 1.970-1, and

(5) The increase in investments in export trade assets, as determined under section 970(c)(2) and paragraph (d)(2) of § 1.970-1.

(g) *Withdrawal of previously excluded subpart F income from qualified investment.* Books or records sufficient to verify the previously excluded subpart F income of the controlled foreign corporation withdrawn from investment in less developed countries for the taxable year must establish—

(1) The sum of the amounts of income excluded from foreign base company income under section 954(b)(1) and paragraph (b)(1) of § 1.954-1 for all prior taxable years,

(2) The sum of the amounts of previously excluded subpart F income withdrawn from investment in less developed countries for all prior taxable years, as determined under section 955(a) and paragraph (b) of § 1.955-1, and

(3) The amount withdrawn from investment in less developed countries for the taxable year as determined under section 955(a) and paragraph (b) of § 1.955-1.

(h) *Withdrawal of previously excluded export trade income from investment.* Books or records sufficient to verify the previously excluded export trade income of the controlled foreign corporation withdrawn from investment for the taxable year must establish the United States shareholder's proportionate share of—

(1) The sum of the amounts by which the subpart F income of such corporation was reduced for all prior taxable years under section 970(a) and paragraph (b) of § 1.970-1,

(2) The sum of the amounts described in section 970(b)(1)(B),

(3) The sum of the amounts of previously excluded export trade income of such corporation withdrawn from investment under section 970(b) and paragraph (c) of § 1.970-1 for all prior taxable years, and

(4) The amount withdrawn from investment under section 970(b) and paragraph (c) of § 1.970-1 for the taxable year.

(i) *Increase in earnings invested in United States property.* Books or records sufficient to verify the increase for the taxable year in earnings invested by the controlled foreign corporations in United States property must establish—

(1) The amount of such corporation's earnings invested in United States property (as defined in section 956(b)(1) and paragraph (a) of § 1.956-2) at the close of the current and preceding taxable years, as determined under paragraph (b) of § 1.956-1,

(2) The amount of excluded property described in section 956(b)(2) and paragraph (b) of § 1.956-2 held by such corporation at the close of such years,

(3) The earnings and profits, to which section 959(c)(1) and paragraph (b)(1) of § 1.959-3 apply, distributed by such corporation during the preceding taxable year, and

(4) The amount of increase in earnings invested by such corporation in United States property which is excluded from the United States shareholder's gross income for the taxable year under section 959(a)(2) and paragraph (c) of § 1.959-1.

[T.D. 6824, 30 FR 6481, May 11, 1965, as amended by T.D. 7211, 37 FR 21436, Oct. 11, 1972]

§ 1.964-5 Effective date of subpart F.

Sections 951 through 964 and §§ 1.951 through 1.964-4 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 7120, 36 FR 10862, June 4, 1971]

EXPORT TRADE CORPORATIONS

§ 1.970-1 Export trade corporations.

(a) *In general.* Sections 970 through 972 provide in general that if a controlled foreign corporation is an export trade corporation for any taxable year the subpart F income of such corporation shall, subject to limitations provided by section 970(a) and paragraph (b) of this section, be reduced by so much of such corporation's export trade income as constitutes foreign base company income. To the extent subpart F income of an export trade corporation is reduced under section 970 and this section, an amount is required by section 970(b) and paragraph (c) of this section to be included in gross income of United States shareholders of the corporation if there is a subsequent decrease in such corporation's investments in export trade assets. See section 971(a) and paragraph (a) of § 1.971-1 for definition of the term "export trade corporation", section 971(b) and paragraph (b) of § 1.971-1 for definition of the term "export trade income", and section 971(c) and paragraph (c) of § 1.971-1 for definition of the term "export trade assets".

(b) *Amount by which export trade income shall reduce subpart F income*—(1) *Deductible amount.* The subpart F income, determined as provided in section 952 and the regulations thereunder but without regard to section 970 and this paragraph, of a controlled foreign corporation which is an export trade corporation for its taxable year shall be reduced by an amount equal to so much of its export trade income as constitutes foreign base company income for such taxable year, but only to the extent that such amount of export trade income does not exceed the limitation determined under subparagraph (2) of this paragraph for such taxable year. See section 972 and § 1.972-1 for rules relating to the consolidation of export trade corporations for purposes of determining the limitations described in subparagraph (2) of this paragraph.

(2) *Limitation on the amount of export trade income deductible from subpart F income.* The amount by which subpart F income of an export trade corporation may be reduced for any taxable year under subparagraph (1) of this paragraph may not exceed whichever of the following limitations is the smallest:

(i) The amount which is equal to 150 percent of the export promotion expenses, as defined in section 971(d) and paragraph (d) of § 1.971-1, of the export trade corporation paid or incurred during the taxable year which are properly allocable to the receipt or the production of so much of its export trade income as constitutes foreign base company income for such taxable year;

(ii) The amount which is equal to 10 percent of the gross receipts (other than from commissions, fees, or other compensation for services), plus 10 percent of the gross amount upon the basis of which are computed commissions, fees, or other compensation for services included in gross receipts, of the export trade corporation received or accrued during the taxable year from, or in connection with, the sale, installation, operation, maintenance, or use of property in respect of which such corporation derives export trade income which constitutes foreign base company income for such taxable year; or

(iii) The amount which bears the same ratio to the increase in investments in export trade assets, as defined in section 970(c)(2) and paragraph (d)(2) of this section, of the export trade corporation for its taxable year as the export trade income which constitutes foreign base company income of such corporation for such taxable year bears to the entire export trade income of the corporation for such year.

Under subdivision (ii) of this subparagraph, in the case of minimum or maximum fee arrangements, the determination shall be made on the basis of the actual gross amounts with respect to which such fees are paid, rather than on the basis of the amounts upon which such minimum or maximum fees are computed. All determinations of limitations under this subparagraph shall be made on an aggregate basis and not with respect to separate items or categories of income described in paragraph (b)(1) of § 1.971-1.

(3) *Determination of export promotion expense limitation.* For purposes of determining the limitation contained in subparagraph (2)(i) of this paragraph for any taxable year of the export trade corporation, there shall be taken into account with respect to those items or categories of export trade income which constitute foreign base company income the entire amount of those export promotion expenses which are directly related to such items or categories of income and a ratable part of any other export promotion expenses which are indirectly related to such items or categories of income, except that no export promotion expense shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such corporation under section 882(c) and the regulations thereunder shall be taken into account.

(4) *Application of section 482.* The limitations provided in section 970(a) and subparagraph (2) of this paragraph shall not affect the authority of the district director to apply the provisions of section 482 and the regulations thereunder, relating to allocation of income and deductions among taxpayers.

(5) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation A is a wholly owned subsidiary of domestic corporation M. Both corporations use the calendar year as the taxable year. For 1963, A Corporation's subpart F income determined under section 952 and the regulations thereunder is $35, the total of its gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $310, its export promotion expenses properly allocable to its export trade income which constitutes foreign base company income are $18, its increase in investments in export trade assets is $32, and its export trade income is $40, of which $30 constitutes foreign base company income and $10 does not constitute foreign base company income. The subpart F income of A Corporation for 1963 as reduced under section 970(a) is $11, determined as follows:

(i) Subpart F income		$35
(ii) Less: $30 export trade income which constitutes foreign base company income, but deduction not to exceed the smallest of the following limitations (smallest of (*a*), (*b*), or (*c*)):		
(*a*) 150 percent of allocable export promotion expenses referred to in subparagraph (2)(i) of this paragraph (150% of $18)	$27	
(*b*) 10 percent of gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph (10% of $310)	$31	

(*c*) Amount which bears to the increase in investments in export trade assets ($32) the same ratio as the export trade income which constitutes foreign base company income ($30) bears to total export trade income ($40) (75% [$30/$40] of $32)	$24	$24
(iii) Subpart F income as reduced under sec. 970(a)		11

Example (*2*). The facts are the same as in example (1), except that A Corporation's export promotion expenses properly allocable to export trade income which constitutes foreign base company income are $14 instead of $18. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $21 (150% of $14) instead of $24. The subpart F income as reduced under section 970(a) is $14 ($35 less $21).

Example (*3*). The facts are the same as in example (1), except that the total amount of A Corporation's gross receipts and gross amounts referred to in subparagraph (2)(ii) of this paragraph is $200 instead of $310. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $20 (10 percent of $200) instead of $24. The subpart F income as reduced under section 970(a) is $15 ($35 less $20).

Example (*4*). The facts are the same as in example (1), except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 5 percent of the gross receipts from M Corporation's sales or a minimum fee of $30. Such gross receipts are $220. The gross amounts taken into account in determining the limitation under subparagraph (2)(ii) of this paragraph are $220. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $22 (10 percent of $220) instead of $24. The subpart F income as reduced under section 970(a) is $13 ($35 minus $22).

Example (*5*). The facts are the same as in example (1), except that A Corporation derives its export trade income which constitutes foreign base company income of $30 in a service arrangement with M Corporation under which it receives as a fee 9 percent of the gross receipts from M Corporation's sales or a maximum fee of $30. Such gross receipts are $400. In such instance, the limitation under (ii)(*b*) of example (1) is $40 (10 percent of $400) instead of $31. The applicable limitation on the amount deductible from A Corporation's subpart F income for 1963 is $24, the smallest of the three limitations. The subpart F income as reduced under section 970(a) is $11 ($35 less $24).

(c) *Withdrawal of previously excluded export trade income*—(1) *Inclusion of withdrawal in income of United States shareholders.* If—

(i) A controlled foreign corporation was an export trade corporation for any taxable year,

(ii) Such corporation in any such taxable year derived subpart F income which, under the provisions of section 970(a) and paragraph (b) of this section, was reduced, and

(iii) Such corporation has in a subsequent taxable year a decrease in investments in export trade assets,

every person who is a United States shareholder, as defined in section 951(b), of such corporation on the last day of such subsequent taxable year on which such corporation is a controlled foreign corporation shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 applies, his pro rata share of the amount of such decrease in investments but only to the extent that such pro rata share does not exceed the limitations determined under subparagraph (2) of this paragraph. A United States shareholder's pro rata share of a controlled foreign corporation's decrease for any taxable year in investments in export trade assets shall be his pro rata share of such corporation's decrease for such year determined under section 970(c)(3) and paragraph (d)(3) of this section.

(2) *Limitations applicable in determining amount includible in income*—(i) *General.* A United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year of such corporation shall, for purposes of determining an amount to be included in the gross income for any taxable year of such shareholder, not exceed the lesser of the limitations determined under (*a*) and (*b*) of this subdivision:

(*a*) Such shareholder's pro rata share of the sum of the controlled foreign corporation's earnings and profits (or deficit in earnings and profits) for the taxable year, computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year, plus his pro rata share of the sum of its earnings and profits (or deficits in earnings and profits) accumulated for prior taxable years beginning after December 31, 1962, or

(*b*)(*1*) Such shareholder's pro rata share of the sum of the amounts by which the subpart F income of such controlled foreign corporation for prior taxable years was reduced under section 970(a) and paragraph (b) of this section, plus

(*2*) Such shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of such controlled foreign corporation for such prior taxable years by reason of the application of section 972 and § 1.972-1, minus

(*3*) Such shareholder's pro rata share of the sum of the amounts which were previously included in his gross income for prior taxable years under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and this paragraph with respect to such controlled foreign corporation.

The net amount determined under (*b*) of this subdivision with respect to any stock owned by the United States shareholder shall be determined without taking into account any amount attributable to a period prior to the date on which such shareholder acquired such stock. See section 1248 and the regulations thereunder for rules governing the treatment of gain from sales or exchanges of stock in certain foreign corporations.

(ii) *Treatment of earnings and profits.* For purposes of determining earnings and profits of a controlled foreign corporation under subdivision (i) (*a*) of this subparagraph, such earnings and profits shall be considered not to include any amounts which are attributable to—

(*a*) Amounts which are, or have been, included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a) (other than an amount included in the gross income of a United States shareholder under section 951(a)(1)(A)(ii) or section 951(a)(1)(B) for the taxable year) and have not been distributed, or

(*b*) (*1*) Amounts which for the current taxable year, are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(*2*) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subdivision apply only in determining the limitation on a United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets. See section 959 and the regulations thereunder for limitations on the exclusion of previously taxed earnings and profits.

(iii) *Rules of application.* The determinations made under subdivision (i) of this subparagraph for purposes of determining the United States shareholder's pro rata share of a controlled foreign corporation's decrease in investments in export trade assets for any taxable year shall be made on the basis of the stock such shareholder owns, within the meaning of section 958(a) and the regulations thereunder, in the controlled foreign corporation on the last day in the taxable year on which such corporation is a controlled foreign corporation even though such shareholder owned more or less stock in such corporation prior to that date. See section 972 and paragraph (b)(3) of § 1.972-1 for rules relating to the allocation of a decrease in investments in export trade assets of export trade corporations in a consolidated chain of such corporations. See section 951(a)(3) and the regulations thereunder for an additional limitation upon the amount of a United States shareholder's pro rata share determined under this paragraph.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation A, which has one class of stock outstanding, is a wholly owned subsidiary of domestic corporation M throughout 1963 and 1964. Both corporations use the calendar year as the taxable year. For 1963, A Corporation qualifies as an export trade corporation and its subpart F income, determined in accordance with the provisions of section 952 and the regulations thereunder, is reduced by $20 under the provisions of section 970(a) and paragraph (b) of this section. Section 972 is assumed not to apply to A Corporation. For 1964, A Corporation has a decrease of $8 in investments in export trade assets. For 1963 and 1964, A Corporation has earnings and profits of $30 (determined under the provisions of subparagraph (2) of this paragraph). Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 which is includible in M Corporation's gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) is $8, determined as follows:

(i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1964 (100% of $8)			$8
(ii) Limitation on amount includible in gross income of M Corporation for 1964 (smaller of (*a*) or (*b*)):			
(*a*) Corporation M's pro rata share of A Corporation's earnings and profits for 1963 and 1964 determined under subparagraph (2) of this paragraph (100% of $30)		$30	
(*b*) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under sec. 970(a) (100% of $20)	$20		
Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 by reason of the application of sec. 972	0		
Total	20		
Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under sec. 951(a)(1)(A)(ii) by reason of the application of sec. 970(b) with respect to A Corporation	0	20	
(iii) Corporation M's pro rata share includible in gross income for 1964 under sec. 951(a)(1)(A)(ii) by reason of the application of sec. 970(b) (smaller of (i) or (ii))			8

Example (2). Assume the same facts as in example (1), except that on February 14, 1965, M Corporation sells 25 percent of its stock in A Corporation to N Corporation. Corporation N is a domestic corporation which also uses the calendar year as a taxable year. For 1965, A Corporation has a decrease of $16 in investments in export trade assets. Corporation A's earnings and profits for 1963 and 1964 (determined under the provisions of subparagraph (2) of this paragraph) are $22 ($30 minus $8). Corporation A's earnings and profits for 1965 are $6 (determined under the provisions of subparagraph (2) of this paragraph). For 1965, M Corporation's pro rata share of A Corporation's decrease in investments in export trade assets which is includible in M Corporation's gross income under section 951(a)(1)(A)(ii) is $9, and N Corporation's pro rata share includible in gross income under such section is $0, determined as follows:

M CORPORATION

(i) Corporation M's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (75% of $16)			$12
(ii) Limitation on amount includible in gross income of M Corporation for 1965 (smaller of (*a*) or (*b*)):			
(*a*) Corporation M's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (75% of $28)		$21	
(*b*) Corporation M's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under sec. 970(a) (75% of $20)	$15		
Plus: Corporation M's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of sec. 972	0		
Total			
Less: Corporation M's pro rata share of the sum of amounts which were previously included in gross income of M Corporation under sec. 951(a)(1)(A)(ii) by reason of the application of sec. 970(b) with respect to A Corporation (75% of $8)	6	9	
(iii) Corporation M's pro rata share includible in gross income for 1965 under sec. 951(a)(1)(A)(ii) by reason of the application of sec. 970(b) (smaller of (i) or (ii))			9

N CORPORATION

(i) Corporation N's pro rata share of A Corporation's decrease in investments in export trade assets for 1965 (25% of $16)			0
(ii) Limitation on amount includible in gross income of N Corporation for 1965 (smaller of (*a*) or (*b*)):			
(*a*) Corporation N's pro rata share of A Corporation's earnings and profits for 1963, 1964, and 1965 determined under subparagraph (2) of this paragraph (25% of $28)		07	

N CORPORATION—Continued

(*b*) Corporation N's pro rata share of amounts by which the subpart F income of A Corporation for 1963 was reduced under sec. 970(a) (amounts prior to 2/14/65 not being taken into account)	0		
Plus: Corporation N's pro rata share of amounts which were not included in subpart F income of A Corporation for 1963 and 1964 by reason of the application of sec. 972 (amounts prior to 2/14/65 not being taken into account)	0		
Total	0		
Less: Corporation N's pro rata share of the sum of amounts which were previously included in gross income of N Corporation under sec. 951(a)(1)(A) (ii) by reason of the application of sec. 970(b) with respect to A Corporation (amounts prior to 2/14/65 not being taken into account)	0	0	
(iii) Corporation N's pro rata share includible in gross income for 1965 under sec. 951(a)(1)(A)(ii) by reason of the application of sec. 970(b) (smaller of (i) or (ii))			0

(d) *Investments in export trade assets*—(1) *Amount of investments.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, export trade assets shall be taken into account on the following bases:

(i) *Working capital.* Working capital to which section 971(c)(1) applies shall be taken into account at the adjusted basis of current assets, determined as of the applicable determination date, less any current liabilities (except as provided in subdivision (iii) of this subparagraph).

(ii) *Other export trade assets.* Inventory to which section 971(c)(2) applies, facilities to which section 971(c)(3) applies, and evidences of indebtedness to which section 971(c)(4) applies, shall be taken into account at their adjusted bases as of the applicable determination date, reduced by any liabilities (except as provided in subdivision (iii) of this subparagraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items on such date. A liability in excess of the adjusted basis of the property which is subject to such liability will not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability. See paragraph (c)(6) of § 1.971-1 for treatment of export trade assets which constitute working capital to which section 971(c)(1) applies and which also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies.

(iii) *Treatment of certain liabilities.* For purposes of subdivisions (i) and (ii) of this subparagraph, a current liability, or a specific charge created with respect to any item of property, principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investments in export trade assets shall be taken into account in such a manner as to properly reflect the controlled foreign corporation's investments in export trade assets; whether a specific charge or current liability is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954-1.

(iv) *Statement required.* If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes an export trade asset on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(2) *Increase in investments in export trade assets.* For purposes of section 970(a) and paragraph (b) of this section, the amount of increase in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in § 1.970-2, the amount by which—

(i) The amount of its investments in export trade assets at the close of such taxable year, exceeds

(ii) The amount of its investments in export trade assets at the close of the preceding taxable year.

(3) *Decrease in investments in export trade assets.* For purposes of section 970(b) and paragraph (c) of this section, the amount of the decrease in investments in export trade assets of a controlled foreign corporation for a taxable year shall be, except as provided in § 1.970-2, the amount by which—

(i) The amount of its investments in export trade assets at the close of the preceding taxable year, minus

(ii) An amount equal to the excess of recognized losses over recognized gains on sales, exchanges, involuntary conversions, assets or other dispositions, of export trade during the taxable year, exceeds

(iii) The amount of its investments in export trade assets at the close of the taxable year.

For purposes of subdivision (ii) of this subparagraph, recognized losses include a write-down of inventory to lower of cost or market in accordance with a method of inventory valuation established or adopted by or on behalf of such foreign corporation under paragraph (c) of § 1.964-1.

[T.D. 6755, 29 FR 12704, Sept. 9, 1964, as amended by T.D. 6795, 30 FR 947, Jan. 29, 1965; T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973]

§ 1.970-2 Elections as to date of determining investments in export trade assets.

(a) *Nature of elections*—(1) *In general.* In lieu of determining the increase under the provisions of paragraph (d)(2) of § 1.970-1, or the decrease under the provisions of paragraph (d)(3) of § 1.970-1, in a controlled foreign corporation's investments in export trade assets for a taxable year in the manner provided in such provisions, a United States shareholder of such corporation may elect, under the provisions of section 970(c)(4) and this section, to determine such increase or decrease in accordance with the provisions of subparagraph (2) of this paragraph or, in the case of export trade assets which are facilities described in section 971(c)(3), in accordance with the provisions of subparagraph (3) of this paragraph. Separate elections may be made under subparagraph (2) and/or (3) of this paragraph with respect to each controlled foreign corporation with respect to which a person is a United States shareholder, within the meaning of section 951(b).

(2) *Election of 75-day rule.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of § 1.970-1 of the amount of such corporation's investments in export trade assets as of the 75th day after the close of the taxable year referred to in such subparagraphs of paragraph (d) of § 1.970-1. The election provided by this subparagraph may be made with respect to export trade assets other than facilities described in section 971(c)(3) or with respect to export trade assets which are facilities or with respect to both types of export trade assets (but the election under this paragraph with respect to export trade assets which are facilities or with respect to both types of export trade assets may be made only if the election provided by subparagraph (3) of this paragraph is not made). If the election provided by this subparagraph is made, the amount of export trade assets with respect to which such election is made at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970-1 shall be the amount of export trade assets which was considered by application of the 75-day rule to be the amount of export trade assets at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corpora-

tion for which the 75-day rule is elected the amount of investments in export trade assets with respect to which such election is made at the close of such preceding year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970-1 shall be the amount of investments in export trade assets at the actual close of such preceding year. In the case of a taxable year of such corporation beginning after December 31, 1962, and before December 31, 1963, the amount of investments in export trade assets with respect to which such election is made alternatively may be determined by the United States shareholder as of the 75th day after the close of the preceding taxable year referred to in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970-1 rather than as of the close of such preceding taxable year.

(3) *Election for export trade assets which are facilities.* A United States shareholder of a controlled foreign corporation may elect with respect to a taxable year of such corporation to make the determinations under subparagraphs (2)(i) and (3)(iii) of paragraph (d) of § 1.970-1 of the amount of such corporation's investments in export trade assets which are facilities described in section 971(c)(3) as of the close of such corporation's taxable year following the taxable year referred to in such subparagraphs of paragraph (d) of § 1.970-1. The election provided by this subparagraph may be made only if the United States shareholder does not elect the 75-day rule of subparagraph (2) of this paragraph with respect to export trade assets which are facilities. If the election provided by this subparagraph is made, the amount of investments in export trade assets which are facilities at the close of the preceding taxable year which is described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970-1 shall be the amount of export trade assets which are facilities which was considered, by reason of the application of the following-year rule provided in this subparagraph with respect to such preceding taxable year, to be the amount of export trade assets which are facilities at the close of such preceding taxable year; except that for the first taxable year of the controlled foreign corporation for which such following-year rule is elected the amount of investments in export trade assets which are facilities at the close of the preceding taxable year described in subparagraphs (2)(ii) and (3)(i) of paragraph (d) of § 1.970-1 shall be the amount of investments in export trade assets which are facilities at the actual close of such preceding taxable year.

(b) *Time and manner of making elections*—(1) *Without consent.* A United States shareholder may, with respect to any controlled foreign corporation, make one or both of the elections described in paragraph (a) (2) or (3) of this section without the consent of the Commissioner by filing a statement to such effect with his return for his taxable year in which or with which ends the first taxable year of such corporation in which—

(i) Such shareholder owns, within the meaning of section 958(a), or is considered as owning, by applying the rules of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and

(ii) Such corporation realizes subpart F income which is reduced under section 970(a) and paragraph (b) of § 1.970-1.

The statement shall contain the name and address of the controlled foreign corporation, identification of such first taxable year of such corporation, and an indication as to which election or elections described in paragraph (a) of this section the United States shareholder is making. If such return has been filed on or before the 90th day after the date these regulations are published in the Federal Register, such United States shareholder shall file such statement with the district director with which the return was filed on or before such 90th day.

(2) *With consent.* A United States shareholder may make one or both of the elections described in paragraph (a) (2) or (3) of this section with respect to any controlled foreign corporation at any time with the consent of the Commissioner. Consent will not be granted unless the shareholder and

the Commissioner agree to the terms, conditions, and adjustments under which the election will be effected. The application for consent to elect shall be made by the shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) in accordance with one or both of the elections provided in paragraph (a) of this section. The application shall include the following information:

(i) The name, address, and taxable year of the United States shareholder;

(ii) The name, address, and taxable year of the controlled foreign corporation;

(iii) A statement indicating which of the elections the shareholder desires to make;

(iv) The amount of the foreign corporation's investments in export trade assets (by a category which includes export trade assets other than facilities and a category which includes only export trade assets which are facilities) at the close of its preceding taxable year;

(v) The shareholder's pro rata share of the sum of the amounts by which the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, was reduced under section 970(a) and paragraph (b) of § 1.970-1;

(vi) The shareholder's pro rata share of the sum of the amounts which were not included in the subpart F income of the foreign corporation, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, by reason of the application of section 972 and § 1.972-1; and

(vii) The shareholder's pro rata share of the sum of the amounts which were previously included in his gross income, for all prior taxable years during which such shareholder was a United States shareholder of such corporation, under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) and paragraph (b) of § 1.970-1 to the foreign corporation.

(c) *Effect of elections*—(1) *In general.* Except as provided in subparagraphs (3) and (4) of this paragraph, an election made under paragraph (a) of this section with respect to a controlled foreign corporation shall be binding on the United States shareholder and—

(i) In the case of the election described in paragraph (a)(2) of this section, shall apply to all investments in export trade assets with respect to which such election is made acquired, or disposed of, by such corporation during the 75-day period following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding 75-day periods of such corporation, or

(ii) In the case of the election described in paragraph (a)(3) of this section, shall apply to all investments in export trade assets which are facilities acquired, or disposed of, by such corporation during the taxable year following its taxable year for which subpart F income is first computed under the election and during all succeeding corresponding taxable years of such corporation.

(2) *Returns.* Any return of a United States shareholder required to be filed before the completion of a period with respect to which determinations are to be made as to a controlled foreign corporation's investments in export trade assets for purposes of computing such shareholder's taxable income shall be filed on the basis of an estimate of the amount of such corporation's investments in export trade assets at the close of the period. If the actual amount of such investments is not the same as the amount of the estimate, the shareholder shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of such shareholder's tax for the year or years with respect to which the incorrect amount was taken into account. The amount of tax, if any, due upon such redetermination shall be paid by the shareholder upon notice and demand by the district director. The amount of tax, if any,

shown by such redetermination to have been overpaid shall be credited or refunded to the shareholder in accordance with the provisions of sections 6402 and 6511 and the regulations thereunder.

(3) *Revocation*—(i) *In general*—(*a*) *Consent required.* Upon application by the United States shareholder, an election made under paragraph (a) of this section may, subject to the approval of the Commissioner, be revoked. Approval will not be granted unless the shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the revocation will be effected.

(*b*) *Revocation of 75-day rule.* In the case of the revocation of an election described in paragraph (a)(2) of this section, the change in the controlled foreign corporation's investments in export trade assets with respect to which such election was made for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be the amount by which—

(*1*) Such corporation's investments in export trade assets with respect to which such election was made at the close of such taxable year exceeds or, if applicable, is exceeded by

(*2*) Such corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of the preceding taxable year of such corporation.

(*c*) *Revocation of following-year rule.* In the case of the revocation of an election described in paragraph (a)(3) of this section, the change in the controlled foreign corporation's investments in export trade assets which are facilities for its first taxable year for which subpart F income or a decrease in investments in export trade assets is computed without regard to the election previously made shall, unless the agreement with the Commissioner provides otherwise, be considered to be zero.

(ii) *Time and manner of applying for consent to revocation*—(*a*) *Application to Commissioner.* The application for consent to revocation of an election shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C., 20224. The application shall be mailed before the close of the first taxable year of the controlled foreign corporation with respect to which the shareholder desires to determine an exclusion under section 970(a) or an inclusion under section 970(b) without regard to such election.

(*b*) *Information required.* The application shall include the following information:

(*1*) The name, address, and taxable year of the United States shareholder;

(*2*) The name, address, and taxable year of the controlled foreign corporation;

(*3*) A statement indicating the election the shareholder desires to revoke under this subparagraph;

(*4*) The information required under subdivisions (iv) through (vii) of paragraph (b)(2) of this section;

(*5*) In the case of an application for consent to revocation of an election made under paragraph (a)(2) of this section, the amount of the foreign corporation's investments in export trade assets with respect to which such election was made at the close of the 75th day after the close of such corporation's taxable year immediately preceding the taxable year of such corporation; and

(*6*) The reasons for the request for consent to revocation.

(4) *Transfer of stock*—(i) *Election of 75-day rule in force.* (*a*) If during any taxable year of a controlled foreign corporation—

(*1*) A United States shareholder who has made the election described in paragraph (a)(2) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(*2*) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange, or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change during the first 75 days of such taxable year in investments in export trade assets with respect to which such election is made to be zero.

(*b*) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which the acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets with respect to which such election is made at the close of the 75th day after the close of such preceding taxable year.

(*c*) If the United States shareholder's successor in interest makes an election under paragraph (a)(2) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets with respect to which such election is made at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(ii) *Election in force with respect to export trade assets which are facilities.* (*a*) If during any taxable year of a controlled foreign corporation—

(*1*) A United States shareholder who has made the election described in paragraph (a)(3) of this section with respect to such corporation sells, exchanges, or otherwise disposes of all or part of his stock in such corporation, and

(*2*) The foreign corporation is a controlled foreign corporation immediately after the sale, exchange or other disposition,

then, with respect to the stock so sold, exchanged, or disposed of, the successor in interest shall consider the controlled foreign corporation's change for such taxable year in investments in export trade assets which are facilities to be zero.

(*b*) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for the taxable year of such corporation in which he acquires such stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its preceding taxable year shall be considered, with respect to the stock so acquired, to be the amount of such corporation's investments in export trade assets which are facilities at the close of the taxable year in which such stock is acquired.

(*c*) If the United States shareholder's successor in interest makes an election under paragraph (a)(3) of this section in order to determine an exclusion under section 970(a) for a taxable year of such corporation subsequent to the taxable year in which he acquired the stock, the amount of the controlled foreign corporation's investments in export trade assets which are facilities at the close of its taxable year immediately preceding such subsequent taxable year shall, with respect to the stock so acquired, be the amount of such corporation's investments in such assets at the actual close of such preceding taxable year.

(d) *Illustrations.* The principles contained in this section are illustrated by the examples set forth in paragraph (d) of § 1.955.3.

[T.D. 6755, 29 FR 12707, Sept. 9, 1964]

§ 1.970-3 Effective date of subpart G.

Sections 970 through 972 and §§ 1.970-1 through 1.972-1 shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders within which or with which such taxable years of such corporations end.

[T.D. 6755, 29 FR 12709, Sept. 9, 1964]

§ 1.971-1 Definitions with respect to export trade corporations.

(a) *Export trade corporations*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, the term "export trade corporation" means a controlled foreign corporation which for the period specified in subparagraph (2) of this paragraph satisfies the conditions specified in subparagraph (3) of this paragraph. However, no controlled foreign corporation may qualify as an export trade corporation for any taxable year beginning after October 31, 1971, unless it qualified as an export trade corporation for any taxable year beginning before such date. In addition, if a corporation fails to qualify as an export trade corporation for a period of any 3 consecutive taxable years beginning after October 31, 1971, then for any taxable year beginning after such 3 year period, such corporation shall not be included within the term "export trade corporation".

(2) *Three-year period.* The period referred to in subparagraph (1) of this paragraph is the 3-year period ending with the close of the controlled foreign corporation's current taxable year, or such part of such 3-year period as occurs on and after the beginning of the corporation's first taxable year beginning after December 31, 1962, whichever period is shorter.

(3) *Gross income requirements.* The conditions referred to in subparagraph (1) of this paragraph are that the controlled foreign corporation derives—

(i) 90 percent or more of its gross income from sources without the United States, and

(ii) (*a*) 75 percent of more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section, or

(*b*) 50 percent or more of its gross income from transactions, activities, or interest described in section 971(b) and paragraph (b) of this section in respect of agricultural products grown in the United States.

(4) *Determination of sources of gross income.* The sources of gross income of a controlled foreign corporation shall be determined for purposes of subparagraph (3)(i) of this paragraph in accordance with the rules for determining sources of gross income set forth in sections 861 through 864 and the regulations thereunder.

(b) *Export trade income*—(1) *General rule.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, the term "export trade income" means the gross export trade income of a controlled foreign corporation derived from transactions, activities, or interest described in subdivisions (i) through (vii) of this subparagraph, less deductions allowed under subdivision (viii) of this subparagraph.

(i) *Sale of export property.* Gross export trade income of a controlled foreign corporation includes gross income it derives from the sale of export property (as defined in paragraph (e) of this section) which it purchases, if the sale is made to an unrelated person for use, consumption, or disposition outside the United States. See section 971(b)(1). As a general rule, property will be presumed to have been sold for use, consumption, or disposition in the country of destination of the sale. However, if at the time of the sale the controlled foreign corporation knows, or should have known from the facts and circumstances surrounding the sales transaction, that the property will probably be used, consumed, or disposed of in the United States, such property will be presumed to have been sold for use, consumption, or disposition in the United States unless the controlled foreign corporation establishes that such property was used, consumed, or disposed of outside the United States. For purposes of this subdivision, export property must be sold by a controlled foreign corporation in essentially the same form in which such property is purchased. Whether export property sold is in essentially the same form in which such property is purchased shall be determined on the basis of all the facts and circumstances in each case. Storage, handling, transportation, packaging, or servicing of property will be considered not to alter the form in which property is purchased. However, manufacture or production, within the meaning of paragraph (a)(4) of § 1.954-3, will be considered to alter the form in which property is purchased and no part of the gross income from the sale of such property will be treated as export trade income. The application of this subdivision may be illustrated by the following example:

Example. Controlled foreign corporation A, incorporated under the laws of foreign country Y, purchases articles manufactured in the United States from domestic corporation M and sells them in the form in which purchased to foreign corporation B, unrelated to A Corporation, for use in foreign countries, X, Y, and Z. The gross income of A Corporation from the purchase and sale of the articles constitutes gross export trade income.

(ii) *Commissions and other income derived in connection with the sale of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of a sale by such corporation in a transaction described in subdivision (i) of this subparagraph or in respect of the sale by any other person of export property to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. Such gross export trade income includes payments received for surveys made prior to, and in connection with, the sale of such export property (whether or not such sales are ultimately consummated). See section 971(b)(1). The term "any person" or "any other person" as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954-1. The application of this subdivision may be illustrated by the following examples:

Example (1). Controlled foreign corporation A, incorporated under the laws of foreign country X, receives from M Corporation a commission equal to 6 percent of the gross selling price of all personal property shipped by M Corporation as a result of services performed by A Corporation in soliciting orders in foreign countries X, Y, and Z. In fulfillment of such orders, M Corporation ships products manufactured by it in the United States. Corporation A does not assume title to the property sold. Gross commissions received by A Corporation from M Corporation in connection with the sale of such property to persons unrelated to A Corporation for use, consumption, or disposition outside the United States constitute gross export trade income.

Example (2). Foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation N, is engaged in the business of manufacturing heavy duty electrical equipment in the United States. By contract, N Corporation engages B Corporation for the purpose of conducting engineering, technical, and financial studies required by N Corporation in the preparation of bids to supply foreign country Y with electrical equipment for a construction project to be undertaken by such country. Corporation N pays B Corporation a fee for the services, all of which are performed in country Y, which is based upon the number of hours of work performed without regard to whether a sale is ultimately consummated. Corporation N does not receive a contract from country Y on its bid to supply equipment. Income derived by B Corporation from performance of the service contract constitutes gross export trade income.

(iii) *Commissions and other income derived in connection with the installation or maintenance of export property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of the installation or maintenance of export property which has been sold by such corporation in a transaction described in subdivision (i) of this subparagraph or by any other person to a person unrelated to the controlled foreign corporation for use, consumption, or disposition outside the United States. See section 971(b)(1). The term "any person" or "any other person" as used in this subdivision includes a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954-1.

(iv) *Commissions and other income derived in connection with the use of patents, copyrights, and other like property.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income derived by such corporation from the performance for any person of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in connection with the use outside of the United States by an unrelated person of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, including gross income derived from obtaining licensees for patents, but only if the patent, copyright, or other like property is acquired, or developed, and owned by the manufacturer, producer, grower, or extractor of any export property, in respect of which the controlled foreign corporation also derives gross export trade income within the meaning of subdivision (i), (ii), or (iii) of this subparagraph. See section 971(b)(2). The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation M, the owner of a patent registered in foreign country X, grants B Corporation, a corporation unrelated to A Corporation, the right to use such patent in foreign country Y in exchange for payment of a royalty. By a separate contract with B Corporation, A Corporation agrees for a gross fee of $100,000 to furnish, by maintaining a staff of technical representatives at the offices of B Corporation, technical services to B Corporation in connection with B Corporation's use of the patent. Corporation A also derives export trade income from the sale of export property which it purchases from M Corporation, the manufacturer of such property, and sells to C Corporation, an unrelated person, for use in country Y by C Corporation. The gross fee of $100,000 received by A Corporation for the furnishing of technical services in connection with B Corporation's use of M Corporation's patent constitutes gross export trade income since the service for which the fee is paid is performed in connection with the use outside the United States by an unrelated person (B Corporation) of a patent owned by a manufacturer (M Corporation) of export property in respect of which the controlled foreign corporation (A Corporation) derives gross export trade income from the sale to an unrelated person (C Corporation) for use outside the United States of export property purchased by it from the manufacturer (M Corporation).

(v) *Income attributable to use of export property by an unrelated person.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, rents, compensation, or other income which is received by such corporation from an unrelated person and is attributable to the use of export property by such unrelated person. See section 971(b)(3). The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A acquires by purchase bottling machines manufactured in the United States and leases the machines to B Corporation, a corporation unrelated to A Corporation, for use by B Corporation in foreign country Y. Gross rental income of A Corporation from the lease of the machines to B Corporation constitutes gross export trade income.

(vi) *Income attributable to the use of export property in the rendition of technical, scientific, or engineering services*—(*a*) *General.* Gross export trade income of a controlled foreign corporation includes gross commissions, fees, compensation, or other income which is received by such corporation from an unrelated person and is attributable to the use of export property in the performance of technical, scientific, or engineering services to such unrelated person. See section 971(b)(3).

(*b*) *Rule of apportionment.* If a commission, fee, or other income received by a controlled foreign corporation from an unrelated person under a contract or arrangement for the performance of technical, scientific, or engineering services is not solely attributable to the use of export property in the performance of such services and the amount of the gross income attributable to such use of export property cannot be established by reference to transactions between other unrelated persons, such gross income shall be an amount which bears the same ratio to total gross income from the contract or arrangement as the cost of the export property consumed in the performance of such services, including a reasonable allowance for depreciation with respect to the export property so used, bears to the total costs and expenses attributable to the production of income under the contract or arrangement.

(c) *Illustration.* The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A is engaged in the seismograph service business in foreign country X. In an effort to establish the probable existence of oil in a concession area it owns in foreign country Y, B Corporation which is unrelated to A Corporation enters into a contract with A Corporation whereby A Corporation is required to make seismographic tests of the area in country Y for a fixed fee of $100,000. In performance of the contract, A Corporation hires a skilled crew to carry out the contract and utilizes equipment and supplies (for example, trucks, seismographic equipment, etc.) which constitute export property. Corporation A cannot establish by reference to transactions between other unrelated persons, the income attributable to the use of the export property in the performance of the contract. Corporation A's total costs and expenses (for example, salaries of the crew, administrative expenses, all supplies, total depreciation on property used in performance of the contract, etc.) incurred in performance of the contract are $80,000. The cost of export property consumed in performance of the contract (for example, dynamite, motor oil, and other supplies which were produced in the United States, reasonable depreciation on trucks and seismographic equipment manufactured in the United States and used in performance of the contract, etc.) is $30,000. Corporation A's gross export trade income from the contract is $37,500, that is, the amount which bears the same ratio to total gross income from the contract ($100,000) as the cost of the export property consumed in the rendition of the services ($30,000) bears to total costs and expenses attributable to the contract ($80,000).

(vii) *Interest from export trade assets.* Gross export trade income of a controlled foreign corporation includes interest derived by it from export trade assets described in section 971(c)(4) and paragraph (c)(5) of this section. See section 971(b)(4).

(viii) *Deductions to be taken into account.* Export trade income of a controlled foreign corporation for any taxable year shall be the amount determined by deducting from the items or categories of gross income described in subdivisions (i) through (vii) of this subparagraph the entire amount of those expenses, taxes, and other deductions properly allocable to such items or categories of income. For purposes of this section, expenses, taxes, and other deductions shall first be allocated to items or categories of gross income to which they directly relate; then, expenses, taxes, and other deductions which cannot definitely be allocated to some item or category of gross income shall be ratably apportioned among all items or categories of gross income, except that no expense, tax, or other deduction shall be allocated to an item or category of income to which it clearly does not apply and no deduction allowable to such controlled foreign corporation under section 882(c) and the regulations thereunder shall be taken into account.

(2) *Cross reference.* For rules governing the determination of gross income and taxable income of a foreign corporation, see § 1.952-2.

(c) *Export trade assets*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, the term "export trade assets" means—

(i) Working capital reasonably necessary for the production of export trade income,

(ii) Inventory of export property held for use, consumption, or disposition outside the United States,

(iii) Facilities located outside the United States for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property, and

(iv) Evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with the payment for services described in section 971(b) (2) or (3) and paragraph (b)(1) (iv), (v), or (vi) of this section.

(2) *Working capital.* For purposes of subparagraph (1)(i) of this paragraph, working capital of a controlled foreign corporation is the excess of its current

assets over its current liabilities. Liabilities maturing in one year or less shall be considered current liabilities. A determination of the amount of working capital of a controlled foreign corporation which is reasonably necessary for the production of export trade income will depend upon the nature and volume of the activities of the controlled foreign corporation which produce export trade income as they exist on the applicable determination date. In determining working capital which is reasonably necessary for the production of export trade income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the controlled foreign corporation following the applicable determination date; anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of export trade income as of the applicable determination date.

(3) *Inventory of export property.* For purposes of subparagraph (1)(ii) of this paragraph, the inclusion of items in inventory shall be determined in accordance with rules applicable to domestic corporations. See §§ 1.471-1 through 1.471-9. Inventory of export property of a controlled foreign corporation includes export property held for use, consumption, or disposition outside the United States regardless of where it is located on the applicable determination date. Thus, such property may be physically located in the United States on such date. However, for property physically located in the United States to constitute export property, it must have been acquired by the controlled foreign corporation with a clear intent that it would dispose of the property for use, consumption, or disposition outside the United States. As a general rule, if during the year following the applicable determination date export property which was physically located in the United States on such date is actually exported for use, consumption, or disposition outside the United States, such property will be deemed held for such purpose on the applicable determination date. On the other hand, the indefinite warehousing of export property in the United States by the controlled foreign corporation, or the subsequent sale of export property by such corporation for use, consumption, or disposition in the United States, will evidence a lack of intent by such corporation on the applicable determination date to hold such property for use, consumption, or disposition outside the United States.

(4) *Facilities located outside the United States*—(i) *In general.* For purposes of subparagraph (1)(iii) of this paragraph, a facility, as defined in subdivision (ii)(*a*) of this subparagraph, will be considered an export trade asset only—

(*a*) If such facility is located outside the United States, and

(*b*) To the extent that such facility is used, within the meaning of subdivision (ii)(*c*) of this subparagraph, by the controlled foreign corporation for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property in essentially the same form in which such property is acquired by such corporation.

Thus, a facility in which property is manufactured or produced, even though export property is used or consumed in the production or becomes a component part of the manufactured article, will not qualify as an export trade asset.

(ii) *Special rules*—(*a*) *Facility defined.* For purposes of subdivision (i) of this subparagraph, the term "facility" includes any asset or group of assets used for the storage, handling, transportation, packaging, servicing, sale, or distribution of export property. Thus, such term includes warehouse, storage, or sales facilities (for example, sales office equipment), transportation equipment (for example, motor trucks, vessels, etc.), and machinery and equipment (for example, packaging equipment, servicing equipment, cranes, forklift trucks used in warehouses, etc.).

(*b*) *Determination of location of transportation facilities.* A transportation facility shall be considered to be located outside the United States for purposes of subdivision (i)(*a*) of this subparagraph if such property is predominantly located outside the United States. As a general rule, on an applicable determination date a transportation facility will be considered to be predominantly located outside the United States if 70 percent or more of the miles traversed (during the 12-month period immediately preceding such determination date or for such part of such period as such facility is owned by the controlled foreign corporation) in the use of such facility are traversed outside the United States or if such facility is located outside the United States at least 70 percent of the time during such period or such part thereof.

(*c*) *Determination of use.* For purposes of subdivision (i)(*b*) of this subparagraph, the extent to which a facility is used in carrying on the activities described in such subdivision depends on the use made of the facility for the 12-month period immediately preceding the applicable determination date or for such part of such period as such facility is owned by the controlled foreign corporation. The method of measuring such use will depend upon the facts and circumstances in each case. However, such determinations of use will generally be made for a facility as a whole and not on the basis of individual items used in the operation of a facility. Thus, a determination as to the use of a warehouse facility will generally be made with respect to the entire facility and not separately for the items used in such warehouse, such as forklift trucks, storage bins, etc.

(5) *Evidences of indebtedness.* For purposes of subparagraph (1)(iv) of this paragraph, the term "evidence of indebtedness" shall mean a note, installment sales contract, a time bill of exchange evidencing a sale on credit, or similar written instrument executed by an unrelated person which evidences the obligation of an unrelated person to pay for export property which an unrelated person purchases for use, consumption, or disposition outside the United States or to pay for services described in section 971(b) (2) or (3) and paragraph (b)(1) (iv), (v), or (vi) of this section which are performed for an unrelated person. Receivables which arise out of the delivery of export property, or the performance of services, which are evidenced by invoices, bills of lading, bills of exchange which do not evidence a sale on credit, sales slips, and similar documents created by the unilateral act of a creditor shall not be considered evidences of indebtedness for purposes of section 971(c)(4).

(6) *Duplication of treatment and priority of application.* No asset which constitutes an export trade asset shall be taken into account more than once in determining the investments in export trade assets of a controlled foreign corporation. Assets which constitute working capital and also constitute inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies shall be taken into account in determining whether the amount of working capital of the controlled foreign corporation is reasonably necessary for the production of export trade income. However, to the extent that the amount of inventory to which section 971(c)(2) applies or evidences of indebtedness to which section 971(c)(4) applies is not included in working capital to which section 971(c)(1) applies on the ground that such amount is not reasonably necessary for the production of export trade income, the amount shall be included under section 971(c)(2) or 971(c)(4), as the case may be, in a controlled foreign corporation's investments in export trade assets.

(d) *Export promotion expenses*—(1) *In general.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, the term "export promotion expenses" means, subject to the provisions of subparagraph (2) of this paragraph, all the ordinary and necessary expenses paid or incurred during the taxable year by the controlled foreign corporation which are reasonably allocable to the receipt or production of export trade income including—

(i) A reasonable allowance for salaries or other compensation for personal services actually rendered for such purpose,

(ii) Rentals or other payments for the use of property actually used for such purpose, and

(iii) A reasonable allowance for the exhaustion, wear and tear, or obsolescence of property actually used for such purpose.

In determining for purposes of this subparagraph whether expenses are reasonably allocable to the receipt or production of export trade income, consideration shall be given to the facts and circumstances of each case. As a general rule, if export trade income results from the sale of export property, export promotion expenses allocable to such income shall include warehousing, advertising, selling, billing, collection, other administrative, and similar costs properly allocable to the marketing activity, but shall not include cost of goods sold, income or similar tax, any expense which does not advance the distribution or sale of export property for use, consumption, or disposition outside the United States, or any expense for which the controlled foreign corporation is reimbursed. If export trade income results from the rental of export property, export promotion expenses allocable to such income shall include a reasonable allowance for depreciation and servicing of such property, and the administrative and similar costs properly allocable to the rental activity. If export trade income results from the performance of services, export promotion expenses shall include a reasonable allowance for compensation of the persons performing services for the controlled foreign corporation in the execution of the service contract or arrangement and administrative expenses reasonably allocable to the service activity. In no case shall income taxes be included in export promotion expenses.

(2) *Expenses incurred within the United States.* No expense incurred within the United States shall be treated as an export promotion expense for purposes of section 971(d) and subparagraph (1) of this paragraph unless at least—

(i) 90 percent of all salaries and other personal service compensation incurred in the receipt or the production of export trade income,

(ii) 90 percent of rents and other payments for the use of property used in the receipt or the production of export trade income,

(iii) 90 percent of the allowances for the exhaustion, wear and tear, or obsolescence of property used in the receipt or the production of export trade income, and

(iv) 90 percent of all other ordinary and necessary expenses reasonably allocable to the receipt or the production of export trade income,

is incurred outside the United States. For this purpose, personal service compensation will be considered incurred at the place where the service is performed (for example, salaries will be considered incurred at the place where the employee works; payments for art work will be considered incurred at the place where the art work is prepared, etc.); rent, depreciation, and other expenses related to real or personal property will be considered incurred at the place where the property is located; and expenses for media advertising will be considered incurred at the place where the advertising is consumed. For such purpose, newspaper or periodical advertising will be considered consumed where the newspaper or periodical is principally distributed, and television and radio advertising will be considered consumed at the place where the audience is primarily located. Technicalities of contract or payment, for example, the place where a contract is executed or the location of a bank account from which payment is made, shall not be determinative of the place where an expense is incurred.

(e) *Export property.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, the term "export property" means property, or any interest in property, which is manufactured, produced, grown, or extracted in the United States. Whether property will be considered manufactured or produced in the United States will depend on the facts and circumstances of each case. As a general rule, if—

(1) The property sold, serviced, used, or rented by the controlled foreign corporation is substantially trans-

formed in the United States prior to its export from the United States, or

(2) The operations conducted in the United States with respect to the property sold, serviced, used, or rented by the controlled foreign corporation, whether performed in the United States by one person or a series of persons in a chain of distribution, are substantial in nature and are generally considered to constitute the manufacture or production of property,

then the property sold, serviced, used, or rented will be considered to have been manufactured or produced in the United States. The rules under paragraph (a)(4)(ii) of § 1.954-3, relating to the substantial transformation of property, and paragraph (a)(4)(iii) of such section, dealing with a substantive test for determining whether property will be treated as having been manufactured or produced, shall apply for purposes of making determinations under this paragraph.

(f) *Unrelated person.* For purposes of sections 970 through 972 and §§ 1.970-1 to 1.972-1, inclusive, the term "unrelated person" means a person other than a related person as defined in section 954(d)(3) and paragraph (e) of § 1.954-1.

[T.D. 6755, 29 FR 12710, Sept. 9, 1964, as amended by T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7533, 43 FR 6603, Feb. 15, 1978]

§ 1.972-1 Consolidation of group of export trade corporations.

(a) *Election to consolidate*—(1) *In general.* One or more United States shareholders (as defined in section 951(b)) owning (within the meaning of section 958(a)) or who are considered as owning by applying the rules of ownership of section 958(b) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of an export trade corporation, which is the top-tier corporation in a chain (within the meaning of subparagraph (2) of this paragraph) of export trade corporations, may, subject to the provisions of this section, elect to consolidate such chain for purposes of determining—

(i) The limitations, described in section 970(a) and paragraph (b)(2) of § 1.970-1, on the amount by which subpart F income of an export trade corporation in such chain shall be reduced as provided in section 970(a) and paragraph (b)(1) of § 1.970-1, and

(ii) The amount includible in gross income of such shareholders under section 951(a)(1)(A)(ii) with respect to such a corporation's decrease in investments in export trade assets to which section 970(b) applies as described in paragraph (c) of § 1.970-1.

(2) *"Chain" defined.* A chain of export trade corporations shall include—

(i) The top-tier export trade corporation referred to in subparagraph (1) of this paragraph which is the first export trade corporation in a chain of ownership described in section 958(a);

(ii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by such top-tier export trade corporation on the last day of its taxable year; and

(iii) All export trade corporations 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned directly by the export trade corporations described in subdivision (ii) of this subparagraph on the last day of the taxable year of the export trade corporation described in subdivision (i) of this subparagraph.

For purposes of this section, a reference to a top-tier corporation shall mean an export trade corporation described in subdivision (i) of this subparagraph, a reference to a second-tier corporation shall mean an export trade corporation described in subdivision (ii) of this subparagraph, and a reference to a third-tier corporation shall mean an export trade corporation described in subdivision (iii) of this subparagraph.

(3) *Inclusion requirement.* If an election is made by a United States shareholder under this paragraph with respect to a chain of export trade corporations (as defined in subparagraph (2) of this paragraph), all export trade corporations which are included in the chain must be included in the consolidation. If such an election is made, the determinations under section 970 shall

be made on a consolidated basis with respect to the entire interest which the electing United States shareholder owns in each of the export trade corporations in the chain, including any minority interests owned directly or indirectly by such shareholder in second-tier and third-tier corporations in the chain. A United States shareholder may elect to consolidate his interest in export trade corporations in one chain of such corporations without electing to consolidate his interest in export trade corporations in other chains.

(4) *Conditions for making initial election*—(i) *Without consent.* The initial election to consolidate a chain of export trade corporations may be made without the consent of the Commissioner only if, immediately before the election to consolidate, each of the export trade corporations to be included in the consolidation is using the same taxable year and has the same elections under section 970(c)(4) and § 1.970-2 in force, or not in force, as the case may be. The election shall be made by the electing shareholder or shareholders with respect to the taxable year in which or with which ends the first taxable year of the top-tier corporation to which the election to consolidate applies and at the time of filing such shareholders' returns for such taxable year or within 90 days after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later. Each United States shareholder making such an election shall attach to his return a statement showing:

(*a*) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which an election is made,

(*b*) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(*c*) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who are making the same election to consolidate and a statement that such shareholders are also making the election.

(ii) *With consent.* If, immediately before the election to consolidate, each of the export trade corporations in a chain of such corporations does not use the same taxable year or does not have the same elections under section 970(c)(4) and § 1.970-2 in force, or not in force, as the case may be, the initial election to consolidate such chain may be exercised by the electing shareholder or shareholders only with the consent of the Commissioner. Consent will not be granted unless each electing United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which such consolidation is to be effected and unless, subject to such terms, conditions, and adjustments as the Commissioner may prescribe, each of the export trade corporations in the chain adopts a common taxable year and has the same elections under section 970(c)(4) and § 1.970-2 in force, or not in force, as the case may be. The application for consent to consolidate shall be made by mailing a letter, signed by each of the electing United States shareholders, to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed before the close of the first taxable year of the top-tier corporation with respect to which the electing shareholder or shareholders desire to make a consolidation or before the close of the 90th day after final regulations under this section are published in the FEDERAL REGISTER, whichever date occurs later, and shall include the statement described in subdivision (i) of this subparagraph.

(5) *Effect of election.* If an election to consolidate a chain of export trade corporations is made for a taxable year of a United States shareholder, such election shall, except as provided in subparagraph (6) of this paragraph, be binding on such shareholder for such taxable year and for all succeeding taxable years. If, in a subsequent taxable year of the United States shareholder, an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain on the last day of the taxable year of the top-tier corporation which ends in or with the subsequent taxable year of such shareholder, the

shareholder's interest in such export trade corporation shall be included in the consolidation to which the election applies, but only if such export trade corporation as of such last day uses the same taxable year and has the same elections under section 970(c)(4) and § 1.970-2 in force, or not in force, as the case may be, as such top-tier corporation. The United States shareholder shall, with respect to such additional export trade corporation, submit with his return for such subsequent taxable year the statement described in subparagraph (4)(i) of this paragraph.

(6) *Termination of election.* An election under this paragraph to consolidate a chain of export trade corporations shall terminate for the first taxable year of the foreign corporation which during the period of consolidation is a top-tier corporation—

(i) At the close of which any foreign corporation which was included in such consolidation for the preceding taxable year ceases to qualify as an export trade corporation or to be eligible under this paragraph for inclusion in such chain,

(ii) At the close of which an export trade corporation for the first time qualifies as a second-tier or third-tier corporation in such chain but does not as of such close of the year use the same taxable year or have the same elections under section 970(c)(4) and § 1.970-2 in force, or not in force, as the case may be, as such top-tier corporation, or

(iii) (*a*) In respect of which the Commissioner, upon application made by a United States shareholder who made the election to consolidate, or his successor in interest, consents to a termination of the election. Approval will not be granted unless the United States shareholder and the Commissioner agree to the terms, conditions, and adjustments under which the termination will be effected.

(*b*) The application for consent to termination shall be made by the United States shareholder's mailing a letter for such purpose to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application shall be mailed before the close of the taxable year of the foreign corporations with respect to which the shareholder desires to terminate the consolidation and shall include the following information:

(*1*) The name, address, and taxable year of each export trade corporation in the chain of such corporations for which the election was made,

(*2*) The amount and percentage of each class of stock owned by such shareholder (within the meaning of section 958), corporation by corporation, in each of such export trade corporations, and

(*3*) A list of the names and addresses, and a description of the ownership interests, of all other United States shareholders, if any, who participated in making the election with such United States shareholder, or their successors in interest, and a statement whether such other persons are or are not terminating the election.

(7) *Election subsequent to initial election.* If a United States shareholder elects under subparagraph (4) of this paragraph to consolidate his interest in a chain of export trade corporations and the election to consolidate such corporations terminates under the provisions of subparagraph (6) of this paragraph, such shareholder may not thereafter elect under this section to consolidate his interest in any corporation which was in that chain of export trade corporations unless he receives the consent of the Commissioner to do so. Application to obtain such consent of the Commissioner shall be made by a letter mailed to the Commissioner of Internal Revenue, Washington, D.C., 20224, before the close of the first taxable year of the top-tier corporation of the chain of export trade corporations in which the election to include such interest is to apply. Such application for consent shall include a statement showing:

(i) With respect to such chain, the information required to be shown in the statement described in subparagraph (4)(i) of this paragraph, and

(ii) The United States shareholder's interest in such chain which was previously included in a consolidation, the taxable years of such previous consolidation, and the manner in which such previous consolidation was terminated.

(8) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example. Domestic corporation M owns 60 percent of the only class of stock of foreign corporation A, and 100 percent of the only class of stock of foreign corporation F, respectively. Corporation A owns 80 percent of the only class of stock of foreign corporations B and C, respectively. Corporation M also owns 20 percent of the stock of B Corporation. Corporation B owns 80 percent of the only class of stock of foreign corporation D. Corporations B and C each own 50 percent of the only class of stock of foreign corporation E. Corporation F owns 100 percent of the only class of stock of foreign corporation G, which owns 100 percent of the only class of stock of foreign corporation H. Corporation F also owns 20 percent of the stock of C Corporation. Domestic corporations N and R own 30 percent and 10 percent, respectively, of the stock of A Corporation. All corporations use the calendar year as a taxable year, and all foreign corporations qualify as export trade corporations for 1963. Corporation M may elect for 1963 to consolidate its interest in the chain (the "A" chain) of export trade corporations which includes corporations A, B, C, D, and E; and Corporation M need not, but may, elect to consolidate its interest in the chain (the "F" chain) of export trade corporations which includes corporations F, G, and H. Consolidation of M Corporation's interest in the "A" chain with its interest in the "F" chain is not permitted. If M Corporation elects to consolidate the "A" chain, M Corporation must include in the consolidation its 20 percent directly owned interest in B Corporation and its 20 percent indirectly owned (through F Corporation) interest in C Corporation. Either N Corporation or R Corporation, or both, may join M Corporation in electing to consolidate their interests in the "A" chain. However, neither N Corporation nor R Corporation may elect to consolidate the "A" chain unless M Corporation also agrees to so elect, because corporations N and R, neither jointly nor separately, own more than 50 percent of the total combined voting power of all classes of stock entitled to vote of A Corporation. If corporations M, N, and R elect to consolidate the "A" chain, the determinations specified in subparagraph (1) of this paragraph will be made on a consolidated basis with respect to such corporations' respective interest in the chain as shown in the following tabulation:

	A %	B %	C %	D %	E %
M Corporation's interest:					
Direct interest	60				
(60% × 80%) + 20% direct interest		68			
(60% × 80%) + 20% indirect interest			68		
(68% × 80%)				54.4	
(68% × 50%) + (68% × 50%)					68
N Corporation's interest:					
Direct interest	30				
(30% × 80%)		24			
(30% × 80%)			24		
(24% × 80%)				19.2	
(24% × 50%) + (24% × 50%)					24
R Corporation's interest:					
Direct interest	10				
(10% × 80%)		8			
(10% × 80%)			8		
(8% × 80%)				6.4	
(8% × 50%) + (8% × 50%)					8
Total interests to which consolidation applies	100	100	100	80	100

(b) *Effect of consolidation*—(1) *Determination of subpart F income, export trade income, etc.* An election under paragraph (a) of this section to consolidate export trade corporations in a chain of such corporations shall have no effect on the determination of the character of income as subpart F income or on the determination of export trade income, export trade income which constitutes foreign base company income, or earnings and profits of the individual export trade corporations in the chain. Thus, the consolidation of export trade corporations under this section shall not have the effect of reducing earnings and profits of such corporations or of changing the characterization of income from that which is, for example, foreign base company income to that which is not. The application of this paragraph may be illustrated by the following example:

Example. Corporation A, incorporated under the laws of foreign country X, and corporation B, incorporated under the laws of foreign country Y, are both wholly owned subsidiaries of domestic corporation M. Corporations A and B both qualify under section 971(a) as export trade corporations. Corporation A purchases personal property produced in the United States from an unrelated person and sells the property to B Corporation for use outside of country X. Corporation B resells the property to an unrelated person for use in foreign country Z. Corporations A and B each derive foreign base company sales income described in § 1.954-3 from the purchase and sale transactions. Consolidation of Corporations A and B under this section does not result in the two transactions being treated as one transaction which is a purchase of property from an unrelated person and a sale of property to an unrelated person or the nonrecognition of gain on the sale of export property by A Corporation to B Corporation.

(2) *Determination of amount by which consolidated subpart F income is reduced*—(i) *In general.* In determining the amount by which the subpart F income of each export trade corporation includible in a consolidation of export trade corporations shall be reduced as provided in section 970(a) and paragraph (b)(1) of § 1.970-1 for any taxable year of consolidation, the limitations provided by section 970(a) and paragraph (b)(2) of § 1.970-1 on such amount for each such export trade corporation shall be determined on the basis of such corporation's separate share of—

(*a*) Amounts included in the total export promotion expense,

(*b*) The total gross receipts from the sale, installation, operation, maintenance, or use of property in respect of which each such corporation derives such export trade income as is properly allocable to the export trade income which constitutes foreign base company income, and

(*c*) The total increase in investments in export trade assets,

of all export trade corporations to which the consolidation applies for the taxable year.

(ii) *Limitations not effective.* If for any taxable year each of the limitations under paragraph (b)(2) of § 1.970-1, determined on a consolidated basis, equals or exceeds the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the subpart F income of each includible corporation shall be reduced under section 970(a) for such year by its separate export trade income which constitutes foreign base company income.

(iii) *Limitation effective.* If for any taxable year one of the limitations under paragraph (b)(2) of § 1.970-1, determined on a consolidated basis, is less than the total export trade income which constitutes foreign base company income of all corporations includible in the consolidation of export trade corporations, the amount by which the subpart F income of each includible corporation shall be reduced under section 970(a) for such year shall be an amount which bears the same ratio to the amount by which the Subpart F income may be reduced on a consolidated basis as the export trade income which constitutes foreign base company income of each includible corporation bears to the total export trade income which constitutes foreign base company income of all export trade corporations includible in the consolidation of export trade corporations.

(iv) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Domestic corporation M owns 100 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as the taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects under this section to consolidate corporations A and B for the entire period here involved. Corporation M elects under paragraph (a)(2) of § 1.970-2 for 1963 to determine both A Corporation's and B Corporation's investments in export trade assets as of the close of the 75th day after the close of such corporations' taxable year.

(b) The following amounts are applicable to corporations A and B for 1964:

	Corporation A	Corporation B
Subpart F income	$100	$200
Export trade income which constitutes foreign base company income	25	75
Other export trade income	10	15
Export promotion expenses allocable to export trade income which constitutes foreign base company income	10	80
Gross receipts from the sale of property in respect of which export trade income which constitutes foreign base company income is derived	400	600
Increase in investments in export trade assets for period beginning with March 16, 1964, and ending with March 16, 1965	35	120

(c) The amount by which subpart F income of corporations A and B is reduced for 1964 on a separate-company basis without regard to section 972 may be determined as set forth in items (i) through (vii) below, and the results of the consolidation of corporations A and B for 1964 are set forth in items (viii) through (x). Assuming an alternative case in which for 1964 the facts are the same as set forth in paragraphs (a) and (b) of this example except that B Corporation incurs export promotion expenses of $50 (rather than $80) which are allocable to the export trade income which constitutes foreign base company income, the results of the consolidation of corporations A and B for such year (a case where one of the limitations under paragraph (b)(2) of § 1.970-1 is effective) are set forth in items (xi) through (xiii):

	A Corporation (1)	B Corporation (2)	Total (3)
(i) Subpart F income	$100	$200	$300
(ii) Export trade income which constitutes foreign base company income	25	75	100
(iii) Other export trade income	10	15	25
(iv) Total export trade income	35	90	125
(v) Limitations under § 1.970-1(b)(2):			
(*a*) Increase in export trade assets limitation:			
($35 × $25/$35)	25		
($120 × $75/$90)		100	
([$35 + $120] × $100/$125)			124
(*b*) Gross receipts limitation:			
(10% of $400)	40		
(10% of $600)		60	
(10% of $1,000)			100
(*c*) Export promotion expenses limitation:			
(150% of $10)	15		
(150% of $80)		120	
(150% of $90)			135
(*d*) Export promotion expenses limitation (alternative case):			
(150% of $10)	15		
(150% of $50)		75	
(150% of $60)			90
(vi) Reduction in subpart F income on a separate company basis determined without regard to section 972 (item (ii), but not to exceed smallest of items (v) (*a*), (*b*), and (*c*), in columns (1) and (2))	15	60	75
(vii) Subpart F income as reduced on a separate company basis (item (i) minus item (vi))	85	140	225
(viii) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii), but not to exceed smallest of items (v) (*a*), (*b*), and (*c*), in column (3))			$100
(ix) Apportionment of reduction in subpart F income (item (ii))	25	75	100
(x) Subpart F income as reduced on a consolidated basis (item (i) minus item (ix))	75	125	200
ALTERNATIVE CASE			
(xi) Reduction in subpart F income on a consolidated basis determined under section 972 (item (ii) but not to exceed smallest of items (v) (*a*), (*b*), and (*d*), in column (3))			9
(xii) Apportionment of reduction in subpart F income (item (xi) times [item (ii) of column (1) over item (ii) of column (3)] and item (xi) times [item (ii) of column (2) over item (ii) of column (3)]); ($90 × $25/$100)	$22.50		
($90 × $75/$100)		$67.50	90
(xiii) Subpart F income as reduced on a consolidated basis (item (i) minus item (xii))	77.50	132.50	210

(3) *Determination of pro rata share of consolidated withdrawal of previously excluded export trade income*—(i) *In general.* If, for any taxable year, there is a decrease in investments in export trade assets under section 970(b) and paragraph (c)(1) of § 1.970-1, determined on a consolidated basis, of export trade corporations includible in a consolidated chain of such corporations, each United States shareholder who has elected under paragraph (a) of this section to consolidate his interest in such chain of corporations shall include in his gross income, under section 951(a)(1)(A)(ii) and the regulations thereunder as an amount to which section 955 applies, his pro rata share of the amount of such consolidated decrease in investments but only to the extent such pro rata share does not exceed the lesser of the limitations provided by section 970(b) and paragraph (c)(2) of § 1.970-1 with respect to such shareholder determined

on a consolidated basis. The consolidated decrease in investments and the consolidated limitations shall be determined by aggregating the applicable amounts determined under paragraph (c) of § 1.970-1 with respect to such shareholder's interest in each corporation includible in the consolidation.

(ii) *Allocation of pro rata share of consolidated decrease in investments in export trade assets.* For purposes of determining the amount referred to in paragraph (c)(2)(i)(*b*)(*3*) of § 1.970-1 for a subsequent taxable year, a United States shareholder's pro rata share of a consolidated decrease in investments determined under subdivision (i) of this subparagraph for the current taxable year shall be allocated to such shareholder's interest in each of the export trade corporations includible in the consolidation in that ratio which—

(*a*) The net amount determined under paragraph (c)(2)(i)(*b*) of § 1.970-1 with respect to such shareholder's interest in such corporation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation) bears to

(*b*) The total of the net amounts determined under paragraph (c)(2)(i) (*b*) of § 1.970-1 with respect to such shareholder's interests in all export trade corporations includible in such consolidation for all prior taxable years (whether or not a taxable year occurring during the period of consolidation).

(iii) *Illustration.* The application of this subparagraph may be illustrated by the following example:

Example. (a) Domestic corporation M owns 60 percent of the only class of stock of controlled foreign corporation A, which, in turn, owns 100 percent of the only class of stock of controlled foreign corporation B. All corporations use the calendar year as a taxable year, and corporations A and B are export trade corporations throughout the period here involved. Corporation M elects to consolidate corporations A and B for the entire period here involved.

(b) The following amounts are applicable to corporations A and B for 1964:

	A (1)	B (2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of § 1.970-1(c)(2))			$100
(ii) M Corporation's pro rata share of consolidated decrease (60%)			60
(iii) M Corporation's pro rata share of earnings and profits for 1963 and 1964 (§ 1.970-1(c) (2)(i)(*a*))	$120	$90	210
(iv) M Corporation's pro rata share of net amount determined under § 1.970-1(c)(2)(i)(*b*) for 1963	180	60	240
(v) Amount includible in M Corporation's gross income for 1964 (smallest of items (ii), (iii), and (iv) in column (3))			60

Corporation M must include $60 in its gross income for 1964 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(*b*)(3) of § 1.970-1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1964 is allocated as follows: to M Corporation's interest in A Corporation, $45 ($60 times $180/$240); and to its interest in B Corporation, $15 ($60 times $60/$240).

(c) The following amounts are applicable to corporations A and B for 1965:

	A(1)	B(2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of § 1.970-1(c)(2))			$150
(ii) M Corporation's pro rata share of consolidated decrease (60%)			90
(iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, and 1965 (§ 1.970-1(c)(2)(i)(*a*))	$100	($20)	80
(iv) M Corporation's pro rata share of the net amount determined under § 1.970-1(c)(2)(i)(*b*) for 1963 and 1964			
($180 – $45)	135		
($60 – $15)		45	
Total			180
(v) Amount includible in M Corporation's gross income for 1965 (smallest of items (ii), (iii), and (iv) in column (3))			80

Corporation M must include $80 in its gross income for 1965 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(*b*)(3) of § 1.970-1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1965 is allocated as follows: to M Corporation's interest in A Corporation, $60 ($80 times $135/$180); and to its interest in B Corporation, $20 ($80 times $45/$180).

(d) The following amounts are applicable to corporations A and B for 1966:

	A(1)	B(2)	Consolidated (3)
(i) Consolidated decrease in investments in export trade assets (determined before application of § 1.970-1(c)(2))			$200
(ii) M Corporation's pro rata share of consolidated decrease (60%)			120
(iii) M Corporation's pro rata share of earnings and profits (and deficits in earnings and profits) for 1963, 1964, 1965, and 1966 (§ 1.970-1(c)(2)(i)(*a*))	$120	$50	170
(iv) M Corporation's pro rata share of the net amount determined under § 1.970-1(c)(2)(i)(b) for 1963, 1964, and 1965			
($180 minus [$45 + $60])	75		
($60 − [$15 + $20])		25	
Total			100
(v) Amount includible in M Corporation's gross income for 1966 (smallest of items (ii), (iii), and (iv) in column (3))			100

Corporation M must include $100 in its gross income for 1966 under section 951(a)(1)(A)(ii) by reason of the application of section 970(b) as its pro rata share of the consolidated decrease in investments in export trade assets; and, for purposes of determining the amount under paragraph (c)(2)(i)(b)(3) of § 1.970-1 with respect to M Corporation's interest in each of corporations A and B for a subsequent taxable year, such consolidated decrease for 1966 is allocated as follows: to M Corporation's interest in A Corporation, $75 ($100 times $75/$100); and to its interest in B Corporation, $25 ($100 times $25/$100).

[T.D. 6754, 29 FR 12714, Sept. 9, 1964]

§ 1.981-0 Repeal of section 981; effective dates.

The provisions of section 981 are not effective for taxable years beginning after December 31, 1976. For the treatment of the community income of aliens and their spouses for taxable years beginning after December 31, 1976, see section 879 and the regulations thereunder.

[T.D. 7670, 45 FR 6929, Jan. 31, 1980]

§ 1.981-1 Foreign law community income for taxable years beginning after December 31, 1966, and before January 1, 1977.

(a) *Election for special treatment*—(1) *In general.* An individual citizen of the United States who meets the requirements of section 981(a)(1) and subparagraph (2) of this paragraph for any open taxable year beginning after December 31, 1966, and before January 1, 1977, may make a binding election with his nonresident alien spouse to have section 981(b) and paragraph (b) of this section apply to their income for such year which is treated as community income under the applicable community property laws of a foreign country or countries. Generally, the community property laws of a foreign country operate upon land situated within its jurisdiction and upon personal property owned by spouses domiciled therein. If the election is made for any taxable year, it shall also apply for all subsequent open taxable years of such citizen and his nonresident alien spouse for which all the requirements of section 981(a)(1) and subparagraph (2) of this paragraph are met, unless the Director of International Operations consents, in accordance with paragraph (c)(2) of this section, to a termination of the election. An election under section 981(a) and this section has no effect for any taxable year beginning before January 1, 1967, for which a separate election, if made, must be made under section 981(c)(1) and § 1.981-2. For the definition of "open taxable year" see section 981(e)(2) and paragraph (a) of § 1.981-3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981-3. If one of the spouses is deceased, see paragraph (d) of § 1.981-3.

(2) *Requirements to be met.* In order for a U.S. citizen and his nonresident alien spouse to make an election under section 981(a) and this section for any taxable year and in order for the election to apply for any subsequent taxable year it is required under section

981(a)(1) that, for each such taxable year, such citizen be (i) a citizen of the United States, (ii) a bona fide resident of a foreign country or countries during the entire taxable year, and (iii) married at the close of the taxable year to an individual who is (*a*) a nonresident alien during the entire taxable year and (*b*), in the case of any such subsequent taxable year, the same nonresident alien individual to whom the citizen was married at the close of the earliest of such taxable years. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated, solely for purposes of making the determination under subdivision (iii) of this subparagraph, as ending on the date of such death. A citizen of the United States shall be considered as not married at the close of his taxable year if he is legally separated from his spouse under a decree of divorce or of separate maintenance. However, the mere fact that spouses have not lived together during the course of the taxable year shall not cause them to be considered as not married at the close of the taxable year. A husband and wife who are separated under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final.

(3) *Determination of residence.* The principles of paragraphs (a)(2) and (b)(7) of § 1.911-1 (26 CFR § 1.911-1 (1978)) shall apply in order to determine for purposes of this paragraph whether a U.S. citizen is a *bona fide* resident of a foreign country or countries during the entire taxable year. The principles of §§ 1.871.2 through 1.871-5 shall apply in order to determine whether the alien spouse of a U.S. citizen is a nonresident during the entire taxable year.

(4) *Manner of electing.* The election under section 981(a) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income for any taxable year to which an election under section 981(a) and this section applies, and the deductions properly allocable to such income, shall be divided between the electing U.S. citizen and nonresident alien spouses in accordance with the rules set forth in section 981(b) and subparagraphs (2) through (6) of this paragraph. Community income for this purpose means all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. A spouse has ownership of the income for this purpose if under the applicable foreign law he has a proprietary vested interest in the income.

(2) *Earned income.* Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services. This subparagraph does not apply, however, to community income (i) derived from any trade or business carried on by the husband or the wife, (ii) attributable to a spouse's distributive share of the income of a partnership to which subparagraph (4) of this paragraph applies, (iii) consisting of compensation for personal services rendered to a corporation which represents a distribution of the earnings and profits of the corporation rather than a reasonable allowance as compensation for the personal services actually performed, or (iv) derived from property which is acquired as consideration for personal services performed.

(3) *Trade or business income.* If any income derived from a trade or business carried on by the husband or wife is community income for the taxable year, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of the trade or business, in which case all of the gross income and deductions shall be treated as the gross income and deductions of the wife. This subparagraph does not apply to any income derived from a trade or business carried on by a partnership of

which both or one of the spouses is a member. For purposes of this subparagraph, income derived from a trade or business includes any income derived from a trade or business in which both personal services and capital are material income producing factors. The term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws of a foreign country. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control of the business despite the provisions of any community property laws of a foreign country vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of the beauty parlor are considered the income and deductions of the wife.

(4) *Partnership income.* If any portion of a spouse's distributive share of the income of a partnership of which such spouse is a member is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not be taken into account in determining the income of the other spouse. If both spouses are members of the same partnership, the distributive share of the income of each spouse which is community income shall be treated as the income of that spouse. A spouse's distributive share of such income of a partnership shall be determined as provided in section 704, and the regulations thereunder.

(5) *Income from separate property.* Any community income for the taxable year, other than income described in section 981(b) (1) or (2) and subparagraph (2), (3), or (4) of this paragraph, which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that the income from such property is community income.

(6) *Other community income.* Any community income for the taxable year, other than income described in section 981(b) (1), (2), or (3), and subparagraph (2), (3), (4), or (5) of this paragraph, shall be treated as the income of that spouse who has a proprietary vested interest in that income under the laws of the foreign country which, in accordance with subparagraph (1) of this paragraph, has jurisdiction to determine that such income is community income. Thus, for example, this subparagraph applies to community income not described in subparagraph (2), (3), (4), or (5) of this paragraph which consists of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children.

(7) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). H, a nonresident alien individual and W, a U.S. citizen, each of whose taxable years is the calendar year, were married throughout 1967. H and W were residents of, and domiciled in, foreign country Z during the entire taxable year. During 1967, H earned $10,000 from the performance of personal services as an employee. H also received $500 in dividend income from stock which under the community property laws of country Z is considered to be the separate property of H. W had no separate income for 1967. Under the community property laws of country Z all income earned by either spouse is considered to be community income, and one-half of such income is considered to belong to the other spouse. In addition, such laws of country Z provide that all income derived from property held separately by either spouse is to be treated as community income and treated as belonging one-half to each spouse. Thus, under the community property laws of country Z, H and W are both considered to have realized income of $5,250 during 1967, even though such laws recognize the stock as the separate property of H. If the election under this section is in effect for 1967, under the rules of subparagraphs (2) and (5) of this paragraph all of the income of $10,500 derived during 1967 shall be treated, for U.S. income tax purposes, as the income of H.

Example (2). The facts are the same as in example (1) except that H is the sole proprietor of a retail merchandising company and such company has a $10,000 profit during 1967. W exercises no management and control over the business. In addition, H is a partner in a wholesale distributing company, and his distributive share of the partnership profit is $5,000. Both of these amounts of income are treated as community income under the community property laws of country Z, and under such laws both H and W are treated as realizing $7,500 of such income. If the election under this section is in effect for 1967, under the rule of subparagraphs (3) and (4) of this paragraph all $15,000 of such income shall be treated as the income of H for U.S. income tax purposes.

Example (3). The facts are the same as in example (1) except that H also received $1,000 in dividends on stock held separately in his name. Under the community property laws of country Z the stock is considered to be community property; and the dividends, to be community income, one-half of such income being treated as the income of each spouse. If the election under this section is in effect for 1967, under the rule of subparagraph (6) of this paragraph, $500 of the dividend income shall be treated, for U.S. income tax purposes, as the income of each spouse.

(c) *Time and manner of making or terminating an election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse shall, for the first taxable year beginning after December 31, 1966, for which an election under section 981(a) and this section is to apply, make the election by filing a return, an amended return, or a claim for refund, whichever is proper, for such taxable year and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for such taxable year. The statement must show the name, address, and account number, if any, of each spouse, the name and address of the executor, administrator, or other person making the election for a deceased spouse, the taxable year to which the election applies, and the name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(b) and paragraph (b) of this section. The statement must be signed by both persons making the election. An election under this section may be made only for a taxable year which, on the date of the election, as defined in paragraph (b) of § 1.981-3, is open within the meaning of section 981(e)(2) and paragraph (a) of § 1.981-3.

(2) *Termination only with consent of Director of International Operations*—(i) *In general.* An election under this section for any taxable year is binding and may not be revoked. The election shall also remain in effect for all subsequent taxable years of the spouses for which the requirements of paragraph (a)(2) of this section are met and which on the date of the election are open, within the meaning of paragraph (a) of § 1.981-3, unless the election is terminated for any such subsequent taxable year or years in accordance with subdivision (ii) of this subparagraph. Any return, amended return, or claim for refund in respect of any such subsequent taxable year for which the election is in effect shall have attached thereto a copy of the statement filed in accordance with subparagraph (1) of this paragraph and an additional signed statement that for such subsequent taxable year the requirements of paragraph (a)(2) of this section are met.

(ii) *Written request to terminate required.* A request to terminate an election under this section for a subsequent taxable year or years shall be made in writing by the persons who made the election and shall be addressed to the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225. The request must include the name, address, and account number, if any, of each spouse and must be signed by the persons making the request. It must specify the taxable year or years for which the termination is to be effective and the grounds which justify the termination. The request shall be filed not later than 90 days before the close of the period for assessing a deficiency against the U.S. citizen for the earliest taxable year of such citizen for which the termination is to be effective. The Director of International Operations may require such other information as may be necessary in order to determine whether the termination will be permitted. A copy of the consent by the Director of International Operations to terminate must be attached to an amended income tax return for each taxable year for which the termination is effective and for which a return has previously been filed.

(Secs. 913(m) (92 Stat. 3106; 26 U.S.C. 913(m)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7330, 39 FR 38372, Oct. 31, 1974, as amended by T.D. 7670, 45 FR 6929, Jan. 31, 1980; T.D. 7736, 45 FR 76143, Nov. 18, 1980]

§ 1.981-2 Foreign law community income for taxable years beginning before January 1, 1967.

(a) *Election for special treatment*—(1) *In general.* For all open taxable years beginning before January 1, 1967, for which an individual citizen of the United States meets the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph, such citizen and his nonresident alien spouse may make a joint election to have section 981(c)(2) and paragraph (b) of this section apply to their income which is treated as community income under the applicable community property laws of a foreign country or countries. However, if the conditions prescribed by section 981(d)(3) and subparagraph (3) of this paragraph are met, the nonresident alien spouse is not required to join in the election and such citizen may make a separate election to have section 981(c)(2) and paragraph (b) of this section apply to such income for such taxable years. An election under section 981(c)(1) and this section shall apply to every open taxable year of such citizen and his nonresident alien spouse beginning before January 1, 1967, for which all the requirements of subparagraphs (A) and (C) of section 981(a)(1) and subparagraph (2) of this paragraph are met. It is immaterial whether such open taxable year is a taxable year subject to the provisions of the 1954 Code, the 1939 Code, or any other internal revenue law in effect before the 1939 Code. An election under section 981(c)(1) and this section has no effect for any taxable year beginning after December 31, 1966. For the definition of "open taxable year" see section 981(e)(2) and paragraph (a) of § 1.981-3. If the citizen and his nonresident alien spouse have different taxable years, see paragraph (c) of § 1.981-3. If one of the spouses is deceased, see paragraph (d) of § 1.981-3. An election under section 981(c)(1) and this section is binding and may not be revoked.

(2) *Requirements to be met.* In order for the citizen of the United States to make an election under this section, whether required to be made jointly with his nonresident alien spouse or permitted to be made separately, it is required under section 981(c)(1) that, for each taxable year to which the election applies, the citizen making the election be (i) a citizen of the United States and (ii) married at the close of the taxable year to an individual who is (*a*) a nonresident alien during the entire taxable year and (*b*), in the case of any such taxable years subsequent to the first, the same nonresident alien individual to whom the citizen was married at the close of such first taxable year. The provisions of paragraph (a)(2) of § 1.981-1 apply to determine whether a U.S. citizen making an election under section 981(c)(1) and this section is married at the close of a taxable year to an individual who is a nonresident alien during the entire taxable year.

(3) *Cases where joint election is not required.* A nonresident alien spouse is not required to join in an election under section 981(c)(1) and this section if the Director of International Operations determines in accordance with paragraph (c)(4) of this section—

(i) That an election under section 981(c)(1) and this section would not affect the liability for Federal income tax of the nonresident alien spouse for any taxable year, whether beginning on, before, or after January 1, 1967, or

(ii) That the effect of the election on the liability of the nonresident alien spouse for Federal income tax for any such taxable year cannot be ascertained and that to deny the election to the U.S. citizen spouse would be inequitable and cause undue hardship to the U.S. citizen.

If in accordance with this subparagraph the nonresident alien spouse is not required to join in the election by the U.S. citizen, the provisions of section 981(d)(2) and paragraph (e) of § 1.981-3 shall not apply so as to extend the period for assessing deficiencies or filing a claim for credit or refund for any taxable year of the nonresident alien spouse.

(4) *Manner of electing.* The election under section 981(c)(1) and this section shall be made in accordance with the applicable rules set forth in paragraph (c) of this section.

(b) *Treatment of community income*—(1) *In general.* Community income, as defined in paragraph (b)(1) of § 1.981-1, for any taxable year beginning before January 1, 1967, to which an election under section 981(c)(1) and this section applies, and the deductions properly allocable to such income, shall be divided between the U.S. citizen and his nonresident alien spouse in accordance with the rules set forth in section 981(c)(2) and subparagraphs (2) and (3) of this paragraph. The income shall be divided in such manner even though the nonresident alien spouse is not required, in accordance with paragraph (a)(3) of this section, to join in the election by the U.S. citizen.

(2) *Earned income, business income, partnership income, and income from separate property.* All community income for any taxable year to which this paragraph applies which is treated as the income of one of the spouses in accordance with section 981(b) (1), (2), or (3) and paragraph (b) (2), (3), (4), or (5) of § 1.981-1 shall be treated as the income of that spouse for purposes of this paragraph.

(3) *Other community income.* All community income for any taxable year to which this paragraph applies, other than income described in subparagraph (2) of this paragraph, shall be treated as the income of the spouse who, for such taxable year, has a greater amount of gross income than the other spouse, determined by adding to the amount of gross income which is treated as the gross income of that spouse in accordance with subparagraph (2) of this paragraph the amount of the gross income for the taxable year which is treated as the separate income of that spouse under the community property laws of the foreign country having jurisdiction to determine the legal ownership of the income. If either spouse dies during a taxable year, the taxable year of the surviving spouse shall be treated as ending on the date of such death for the purpose of determining which spouse has the greater amount of gross income for such taxable year. Moreover, if the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the periods for which the amounts of gross income are to be compared under this subparagraph are (i) the taxable year of the citizen and (ii) that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen. See paragraph (c) of § 1.981-3.

(c) *Time and manner of making election*—(1) *In general.* A citizen of the United States and his nonresident alien spouse or, if subparagraph (4) of this paragraph applies, such citizen alone may make an election under section 981(c)(1) and this section at any time on or after November 13, 1966, for each and every taxable year beginning before January 1, 1967, which on the date of the election, as defined in paragraph (b) of § 1.981-3, is open within the meaning of section 981(e)(2) and paragraph (a) of § 1.981-3. The election shall be made by filing a return, an amended return, or a claim for refund, whichever is proper, for each taxable year to which the election applies and attaching thereto a statement that the election is being made and that the requirements of paragraph (a)(2) of this section are met for each such taxable year. The statement must also show the information required by subparagraph (2) of this paragraph and must, where applicable, be signed by both persons making the election.

(2) *Information required.* The statement described in subparagraph (1) of this paragraph must show—

(i) The name, address, and account number, if any, of each spouse,

(ii) The name and address of the executor, administrator, or other person making the election for a deceased spouse,

(iii) The taxable years to which the election applies,

(iv) The office of the district director, or the service center, where the return or returns, if any, for such taxable year or years were filed,

(v) The dates on which such return or returns, if any, were filed and on which the tax for such taxable year or years was paid, if the tax has been paid, and

(vi) The name of the foreign country or countries having jurisdiction to determine the ownership of any income being treated in accordance with section 981(c)(2) and paragraph (b) of this section.

(3) *Place for filing.* Any return, amended return, or claim for refund filed under subparagraph (1) of this paragraph in respect of any taxable year shall be filed with the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225. (See § 1.6091-3.)

(4) *Determination that joint election is not required.* A U.S. citizen spouse entitled to make an election under section 981(c)(1) and this section for open taxable years beginning before January 1, 1967, may apply to the Director of International Operations for a determination under section 981(d)(3) that the nonresident alien spouse is not required to join in the election by such citizen. This application shall be made by filing with the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225, a statement setting forth the same information required by subparagraph (2) of this paragraph and such other information as is required by the Director of International Operations to justify a claim that the requirements of section 981(d)(3) and paragraph (a)(3) of this section are met. The Director of International Operations shall notify the U.S. citizen by letter of his determination with respect to the application. If the determination is that the nonresident alien spouse is not required to join in the election, a copy of the letter of determination shall be attached to each return, amended return, or claim for refund, to be filed pursuant to subparagraph (1) of this paragraph.

[T.D. 7330, 39 FR 38373, Oct. 31, 1974]

§ 1.981-3 Definitions and other special rules.

(a) *Open taxable years.* (1) For purposes of paragraph (a) of § 1.981-1, and paragraph (a) of § 1.981-2, a taxable year of the U.S. citizen, and the taxable year or years of his nonresident alien spouse ending or beginning within such taxable year of such citizen, shall be treated as open if the period prescribed by section 6501(a) (or section 6501(c)(4) if the period is extended by agreement) for assessing a deficiency against the citizen for his taxable year has not expired before the date of the election, determined under paragraph (b) of this section. Thus, for example, a taxable year of a U.S. citizen beginning before January 1, 1967, is open for purposes of this subparagraph if, before the election under section 981(c)(1) and § 1.981-2, such citizen has never filed a return for such year and a return was required under section 6012 without reference to section 981. For example, if a U.S. citizen spouse on a calendar year basis who has never filed a return for 1960 decides in 1975 that he wishes to make the election under section 981(c)(1) and § 1.981-2 in order to avoid being subject to tax for 1960 on his share of the community income for that year, he may in 1975 elect the benefits of section 981(c)(2) by filing an election in accordance with paragraph (c) of § 1.981-2. In such case, a taxable year or years of the nonresident alien spouse of such citizen ending or beginning within 1960 shall be treated in 1975 as an open taxable year.

(2) Subparagraph (1) of this paragraph shall apply even though the period prescribed by section 6501 for assessing a deficiency against the nonresident alien spouse for his taxable year or years ending or beginning within the taxable year of the U.S. citizen has expired before the election is made.

(3) If either spouse dies during a taxable year to which an election under § 1.981-1 or § 1.981-2 applies, the taxable year of the decedent and the surviving spouse shall be determined under this paragraph without regard to section 981(e)(4), relating to death

of spouse during the taxable year. See paragraph (a)(2) of § 1.443-1.

(4) For definition of the term "taxable year", see section 441(b) and the regulations thereunder.

(b) *Date of election.* (1) For purposes of § 1.981-1 and this section the date of an election made under section 981(a) and § 1.981-1 is the date on which the return, amended return, or claim for refund required by paragraph (c)(1) of § 1.981-1 is filed.

(2) For purposes of § 1.981-2 and this section the date of an election made under section 981(c)(1) and § 1.981-2 is the date on which the returns, amended returns, or claims for refund, required by paragraph (c)(1) of § 1.981-2 are filed.

(3) For provisions treating timely mailing as timely filing, see section 7502 and the regulations thereunder.

(c) *Spouses with different taxable years.* If the U.S. citizen and his nonresident alien spouse do not have the same taxable year, as defined in section 441(b) and the regulations thereunder, the election under § 1.981-1 or § 1.981-2 shall apply to each taxable year of such citizen in respect of which the election is made and to that period falling within the consecutive taxable years of the nonresident alien spouse which coincides with the period covered by such taxable year of the citizen.

(d) *Election on behalf of deceased spouse.* Any election, statement, or request, required to be made under paragraph (c) of § 1.981-1, or paragraph (c) of § 1.981-2, by one of the spouses may, if such spouse is deceased, be made by the executor, administrator, or other person charged with the property of such deceased spouse.

(e) *Extension of period of limitations on assessment or refund*—(1) *Assessment of deficiency.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and § 1.981-1, or under section 981(c)(1) and § 1.981-2, is properly made, the period within which a deficiency may be assessed for any taxable year to which the election applies shall, to the extent the deficiency is attributable to the application of such election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(2) *Refund of tax.* Except as provided in subparagraph (3) of this paragraph, if an election under section 981(a) and § 1.981-1, or under section 981(c)(1) and § 1.981-2, is properly made, the period within which a claim for credit or refund of an overpayment for any taxable year to which the election applies may be filed shall, to the extent the overpayment is attributable to the application of the election, not expire before one year after the date of the election, determined under paragraph (b) of this section.

(3) *Exception in case of nonelecting alien.* Subparagraphs (1) and (2) of this paragraph shall not apply to any taxable year of a nonresident alien spouse who, in accordance with paragraph (a)(3) of § 1.981-2, is not required to join in the election by the U.S. citizen spouse under section 981(c)(1) and § 1.981-2.

(f) *Payment of interest for extension period.* To the extent that an overpayment or deficiency for any taxable year is attributable to an election made under § 1.981-1 or § 1.981-2, no interest shall be allowed or paid for any period ending with the day before the date which is one year after the date of the election, determined under paragraph (b) of this section.

[T.D. 7330, 39 FR 38374, Oct. 31, 1974]

DOMESTIC INTERNATIONAL SALES CORPORATIONS

§ 1.991-1 Taxation of a domestic international sales corporation.

(a) *In general.* A corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for such taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax. Thus, for example, a corporation which is a DISC for a taxable year is not subject for such year to the corporate income tax (section 11), the minimum tax on tax preferences (sections 56 through 58), or the accumulated earnings tax (sections 531 through 537). A DISC is liable for the payment of all taxes payable by corporations under other subtitles of the Code, such as, for example, income taxes withheld at the source and other employment taxes under subtitle C and the interest equalization tax and other miscellaneous excise taxes imposed by subtitle D. In addition, a DISC is subject to the provisions of chapter 3 of subtitle A (including section 1461), relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds. See § 1.992-1 for the definition of the term "DISC."

(b) *Determination of taxable income*—(1) *In general.* Although a DISC is not subject to tax under subtitle A of the Code (other than chapter 5 thereof), a DISC's taxable income shall be determined for each taxable year in order to determine, for example, the amount deemed distributed for that taxable year to its shareholders pursuant to § 1.995-2. Except as otherwise provided in the Code and the regulations thereunder, the taxable income of a DISC shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, for example, a DISC chooses its method of depreciation, inventory method, and annual accounting period in the same manner as if it were a corporation which had not elected to be treated as a DISC. Any elections affecting the determination of taxable income shall be made by the DISC. Thus, as a further example, a DISC which makes an installment sale described in section 453 is able to avail itself of the benefits of section 453: *Provided,* The DISC complies with the election requirements of such section. See § 1.995-2(e) and § 1.996-8 and the regulations thereunder for rules relating to the application for a taxable year of a DISC of a deduction under section 172 for a net operating loss carryback or carryover or of a capital loss carryback or carryover under section 1212.

(2) *Choice of method of accounting.* A DISC may, generally, choose any method of accounting permissible under section 446(c) and the regulations thereunder. However, if a DISC is a member of a controlled group (as defined in § 1.993-1(k)), the DISC may not choose a method of accounting which, when applied to transactions between the DISC and other members of the controlled group, will result in a material distortion of the income of the DISC or any other member of the controlled group. Such a material distortion of income would occur, for example, if a DISC chooses to use the cash method of accounting where the DISC acts as commission agent in a substantial volume of sales of property by a related corporation which uses the accrual method of accounting and which customarily pays commissions to the DISC more than 2 months after such sales. As a further example, a material distortion of income would occur if a DISC chooses to use the accrual method of accounting where the DISC leases a substantial amount of property from a related corporation which uses the cash method of accounting, if the DISC customarily accrues any portion of the rent on such property more than 2 months before the rent is paid. Changes in the method of accounting of a DISC are subject to the requirements of section 446(e) and the regulations thereunder.

(3) *Choice of annual accounting period*—(i) *In general.* A DISC may choose its annual accounting period without regard to the annual accounting period of any of its stockholders. In general, changes in the annual accounting period of a DISC are subject to the requirements of section 442 and the regulations thereunder.

(ii) *Transition rule for change in taxable year in order to become a DISC.* A corporation may, without the consent of the Commissioner, change its annual accounting period and adopt a new taxable year beginning on the first day of any month in 1972: *Provided,* That—

(*a*) Such change has the effect of accelerating the time as of which such corporation can become a DISC,

(*b*) The Commissioner is notified of such change by means of a statement filed (with the regional service center with which such corporation files its election to be treated as a DISC) not later than the end of the period during which such corporation may file an election to be treated as a DISC for such new taxable year, and (*c*) The short period required to effect such change is not a taxable year in which such corporation has a net operating loss as defined in section 172.

Thus, for example, if a corporation which uses the calendar year for its taxable year does not complete arrangements to become a DISC until May 15, 1972, such corporation can, pursuant to this subdivision, change its annual accounting period and adopt a taxable year beginning on the first day of any month in 1972 after May. A change to a new annual accounting period made pursuant to this subdivision is effective only if the corporation which makes such change qualifies as a DISC for such new period. A corporation may change its annual accounting period and adopt a new taxable year pursuant to this subdivision without regard to the provisions of § 1.1502-76 (relating to the taxable year of members of a group). A copy of the statement described in (*b*) of this subdivision shall be attached to the return of a corporation for the new taxable year to which such corporation changes pursuant to this subdivision. A corporation which changes its annual accounting period pursuant to this subparagraph will not be permitted under section 442 to change its annual accounting period at any time before 1982, except with the consent of the Commissioner as provided in § 1.442-1(b)(1) or pursuant to subparagraph (4) of this paragraph.

(4) *Transition rule for change of taxable year of certain DISC's.* In the case of a DISC all of the shares of which are held by a single shareholder or by members of a group who file a consolidated return, such DISC may (without the consent of the Commissioner) change its annual accounting period and adopt a taxable year beginning in 1972 which is the same as the taxable year of such shareholder or the members of such group. A change to a new annual accounting period may be made by a DISC pursuant to this subparagraph even if such DISC has changed its annual accounting period pursuant to subparagraph (3)(ii) of this paragraph.

(5) *Transition rule for beginning of first taxable year of certain corporations.* If a corporation organized before January 1, 1972, neither acquires assets (other than cash or other property acquired as consideration for the issuance of stock) nor begins doing business prior to January 1, 1972, the first taxable year of such corporation is deemed to begin at the time such corporation acquires any asset (other than cash or other property acquired as consideration for the issuance of stock) or begins doing business, whichever is earlier: *Provided,* That such corporation is a DISC for such first taxable year. If the corporation enters into a supplier's agreement described in § 1.993-1(l)(1), then for purposes of this subparagraph the agreement is deemed to be an asset acquired by such corporation as of the date property is first purchased or sold, or services are first performed, subject to such agreement. For purposes of this subparagraph, the consummation of a supplier's agreement described in § 1.993-1(l)(1) is not considered to be an act of doing business. For purposes of § 1.6012-2(a), such corporation is treated as not coming into existence until the beginning of such first taxable year.

(c) *Effective date.* The provisions of this section and the regulations under sections 992 through 997 apply with respect to taxable years ending after December 31, 1971, except that a corporation may not be a DISC for any taxable year beginning before January 1, 1972.

(d) *Related statutes.* For rules relating to the transfer, during a taxable year beginning before January 1, 1976, to a DISC of assets of an export trade corporation (as defined in section 971), where a parent owns all the outstanding stock of both such DISC and such export trade corporation, see section 505(b) of the Revenue Act of 1971 (85 Stat. 551). For rules regarding limitations on the qualification of a corporation as an export trade corporation for any taxable year beginning after October 31, 1971, see section 971(a)(3).

[T.D. 7323, 39 FR 34402, Sept. 25, 1974]

§ 1.992-1 Requirements of a DISC.

(a) *"DISC" defined.* The term "DISC" refers to a domestic international sales corporation. The term "DISC" means a corporation which, for a taxable year—

(1) Is duly incorporated and existing under the laws of any State or the District of Columbia,

(2) Satisfies the gross receipts test described in paragraph (b) of this section,

(3) Satisfies the assets test described in paragraph (c) of this section,

(4) Satisfies the capitalization requirement described in paragraph (d) of this section,

(5) Satisfies the requirement that an election to be treated as a DISC be in effect for such year, as described in paragraph (e) of this section,

(6) Has its own bank account on each day of the taxable year, except as provided in paragraph (i) of this section,

(7) Maintains separate books and records, and

(8) Is not an ineligible corporation described in paragraph (f) of this section.

A corporation which satisfies the requirements described in subparagraphs (1) through (8) of this paragraph for a taxable year is treated as a separate corporation for Federal tax purposes and qualifies as a DISC, even though such corporation would not be treated (if it were not a DISC) as a corporate entity for Federal income tax purposes. An association cannot qualify as a DISC even if such association is taxable as a corporation pursuant to section 7701(a)(3). In addition, a corporation created or organized in, or under the law of, a possession of the United States cannot qualify as a DISC. The rules contained in this paragraph constitute a relaxation of the general rules of corporate substance otherwise applicable under the Code. The separate incorporation of a DISC is required under section 992(a)(1) to make it possible to keep a better record of the income which is subject to the special treatment provided by sections 991 through 996, but this does not necessitate in all other respects the separate relationships which otherwise would be required between a parent corporation and its subsidiary. However, this relaxation of the general rules of corporate substance does not apply with respect to other corporations in other contexts. In the case of a transaction between a DISC and a person related to such DISC for purposes of section 482, see § 1.993-1(l) for rules for determining whether income is income of a DISC to which the intercompany pricing rules authorized by section 994 apply.

(b) *Gross receipts test.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, 95 percent or more of its gross receipts (as defined in § 1.993-6) for such year must consist of qualified export receipts (as defined in § 1.993-1). Gross receipts for a taxable year are determined in accordance with the method of accounting adopted by the corporation pursuant to § 1.991-1(b)(2). However, for rules regarding gross receipts in the case of a commission sale by such corporation, see § 1.993-6.

(c) *Assets test*—(1) *In general.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, the adjusted basis (determined under section 1011) of its qualified export assets at the close of such year must equal or exceed 95 percent of the sum of the adjusted bases (determined under section 1011) of all assets of such corporation at the close of such year.

(2) *Assets acquired to meet assets test.* For purposes of determining whether the requirements of subparagraph (1) of this paragraph are satisfied by a corporation at the end of a taxable year, an asset which is a qualified export asset is treated as not being an asset of such corporation at such time if such asset is held for a total of 60 days or less and is acquired directly or indirectly through borrowing, unless the acquisition of such asset is established to the satisfaction of the Commissioner or his delegate to have been for bona fide purposes. Such acquisition is deemed to have been for bona fide purposes if, for example, it is made in the usual course of the corporation's trade or business.

(d) *Capitalization requirement*—(1) *In general.* In order for a corporation to be a DISC for a taxable year, such corporation must have, on each day of such taxable year, only one class of stock, and the par value (or, in the case of stock without par value, the stated value) of such corporation's outstanding stock, and the amount of cash or other property which was paid in, must be, on each day of such taxable year, at least $2,500. In the case of a corporation which elects to be treated as a DISC for its first taxable year, the requirements of this subparagraph are satisfied if such corporation has no more than one class of stock at any time during such period and if the par value (or, in the case of stock without par value, the stated value) of such corporation's outstanding stock, and the amount of cash or other property paid in, is at least $2,500 on the last day of the period within which such election must be made and on each succeeding day of such year. For purposes of this subparagraph, property paid in does not include notes or other evidences of indebtedness, under which a shareholder of such corporation is an obligor, received by such corporation in return for its stock. For purposes of this subparagraph, the stated value of shares is the aggregate amount of the consideration paid for such shares which is not allotted to paid in surplus, or other surplus. If a corporation has a realized or unrealized loss during a taxable year which results in the impairment of all or part of the capital required under this subparagraph, such impairment does not result in disqualification under this subparagraph, provided that such corporation does not take any legal or formal action under State law to reduce capital for such year below the amount required under this subparagraph. For example, if a corporation issues ten shares of stock at a par value of $250 each, and received property other than cash worth $2,500 in return, and because of market fluctuations the value of such property is reduced to $1,500 at any time during a taxable year, such corporation is not disqualified from being treated as a DISC for that year solely because of such impairment of its capital. The sale, exchange, or other disposition of cash or other property paid in for stock shall not result in the failure of a corporation to qualify as a DISC pursuant to this subparagraph, unless such transaction is a purchase of, or exchange for, a note or other evidence of indebtedness under which a shareholder of such corporation is an obligor.

(2) *Treatment of debt payable to shareholders*—(i) *In general.* Purported debt of a DISC payable to any person, whether or not such person is a shareholder or a member of a controlled group (as defined in § 1.993-1(k)) of which such DISC is a member, is treated as debt for all purposes of the Code, provided that such purported debt—

(*a*) Would qualify as debt (applying section 385, where applicable) for purposes of the Code if the DISC were a corporation which did not qualify as a DISC,

(*b*) Notwithstanding section 385, qualifies under subdivision (ii) of this subparagraph, or

(*c*) Are trade accounts payable described in subdivision (iii) of this subparagraph.

Such debt is not treated as stock, and interest payable by the DISC on such debt is treated as interest by both the DISC and the holder of such debt. Payment of the principal of such debt by a DISC does not constitute the payment of a dividend by such DISC. The provisions of this subparagraph apply for a taxable year of a DISC, even though debt described in this subparagraph would be treated as stock of the corporation if such corporation did not qualify as a DISC for such year.

(ii) *Safe harbor rule.* Purported debt of a DISC will in no event be treated as other than debt for purposes of subdivision (i) of this subparagraph if—

(*a*) It is a written obligation to pay a sum certain on or before a fixed maturity date,

(*b*) Interest is payable on such purported debt at an arm's length interest rate (as determined under § 1.482-2(a)(2)), expressed as a fixed dollar amount or a fixed percentage of principal,

(*c*) Such purported debt is not convertible into stock or into other purported debt unless such other purported debt qualifies under this subparagraph as debt of the DISC.

(*d*) Such purported debt does not confer voting rights upon its holder, except in the event of default thereon, and

(*e*) Interest and principal are paid in accordance with the terms of such purported debt or with any modification of such terms consistent with (*a*) through (*d*) of this subdivision.

The determination of whether purported debt of a DISC constitutes debt described in this subdivision is made without regard to the proportion of debt of the DISC held by any of its shareholders, to the ratio of the outstanding debt of the DISC to its equity, or to the amount of outstanding debt of such DISC. The provisions of (*e*) of this subdivision do not prevent the modification of the terms of debt of a DISC where, for example, a DISC becomes unable to make timely payments of principal required under such terms, provided that such modification is consistent with (*a*) through (*d*) of this subdivision.

(iii) *Trade accounts payable.* Trade accounts payable of a DISC which arise in the normal course of its trade or business (such as in consideration for inventory or supplies) constitute debt of the DISC (whether or not such accounts payable are debt described in subdivision (i) (*a*) or (*b*) of this subparagraph), provided that such accounts are payable within 15 months after they arise. If such accounts are payable more than 15 months after they arise, they are debt of such DISC only if they are debt described in subdivision (i) (*a*) or (*b*) of this subparagraph.

(iv) *Relation of subparagraph to other corporations.* The provisions of this subparagraph generally constitute a relaxation of the ordinary rules used in determining whether purported debt of a corporation is debt or equity. This relaxation is in recognition of the principle that a corporation may qualify as a DISC even though it has relatively little capital. This relaxation does not apply with respect to purported debt of other corporations in other contexts. The provisions of subdivisions (i), (ii), and (iii) of this subparagraph apply only for taxable years for which a corporation qualifies (or is treated) as a DISC.

(3) *Classes of stock* [Reserved]

(e) *Election in effect.* In order for a corporation to be a DISC for a taxable year, an election to be treated as a DISC must be made by such corporation pursuant to § 1.992-2 and must be in effect for such taxable year. A corporation does not become or remain a DISC solely by making such an election. A corporation is a DISC for a taxable year only if such an election is in effect for that year and the corporation also satisfies the requirements of paragraphs (a) through (d) of this section. See § 1.992-2 for rules regarding the time and manner of making such an election.

(f) *Ineligible corporations.* The following corporations shall not be eligible to be treated as a DISC—

(1) A corporation exempt from tax by reason of section 501,

(2) A personal holding company (as defined in section 542),

(3) A financial institution to which section 581 or 593 applies,

(4) An insurance company subject to the tax imposed by Subchapter L,

(5) A regulated investment company (as defined in section 851(a)),

(6) A China Trade Act corporation receiving the special deduction provided in section 941(a), or

(7) An electing small business corporation (as defined in section 1371(b)).

(g) *Status as DISC after having filed return as a DISC.* Under section 992(a)(2), notwithstanding the failure of a corporation to meet the requirements of paragraph (a) of this section for a taxable year, such corporation will be treated as a DISC for purposes of the Code for such taxable year (and, thus, will not be able to claim that it is not eligible to be a DISC) if—

(1) Such corporation files a return as a DISC for such taxable year,

(2) Such corporation does not notify the district director, more than 30 days before the expiration of the period of limitation (including extensions thereof) on assessment for underpayment of tax for such taxable year (as determined under section 6501 and the regulations thereunder), that it is not a DISC for such taxable year, and

(3) The Internal Revenue Service has not issued, within such period of limitation (including extensions there-

of) on assessment for underpayment of tax for such taxable year, a notice of deficiency based on a determination that such corporation is not a DISC for such taxable year.

A corporation is treated as a DISC, for all purposes, pursuant to the provisions of this paragraph for any taxable year for which it meets the requirements of this paragraph, even if such corporation is an ineligible corporation described in paragraph (f) of this section for such taxable year. Thus, for example, a corporation which is treated as a DISC for a taxable year pursuant to this paragraph is treated as a DISC for that taxable year for purposes of § 1.992-2(e)(3) (relating to the termination of a DISC election if a corporation is not a DISC for each of any 5 consecutive taxable years). If a corporation is treated as a DISC for a taxable year pursuant to this paragraph, persons who held stock of such corporation at any time during such taxable year are treated, with respect to such stock, as holders of stock in a DISC for the period or periods during which they held such stock within such taxable year.

(h) *Definition of "former DISC".* Under section 992(a)(3), the term "former DISC" refers to a corporation which is not a DISC for a taxable year but which was (or was treated as) a DISC for a prior taxable year. However, a corporation is not a former DISC for a taxable year unless such corporation has, at the beginning of such taxable year, undistributed previously taxed income (as defined in § 1.996-3(c) or accumulated DISC income (as defined in § 1.996-3(b)). A corporation which is a former DISC for a taxable year is a former DISC for all purposes of the Code.

(i) *Time for satisfying the separate bank account requirement.* The separate bank account requirement referred to in paragraph (a)(6) of this section shall be satisfied for a taxable year by a corporation if—

(1) In the case of a corporation which elects to be treated as a DISC for its first taxable year, such corporation has a separate bank account either—

(i) Within 90 days after the beginning of such taxable year and on each succeeding day of such taxable year or

(ii) Within the period prescribed in subparagraph (2) of this paragraph, if applicable.

(2) For any taxable year which—

(i) Ends before October 31, 1974, such corporation has a separate bank account at any time during that taxable year or

(ii) Ends with or includes October 31, 1974, such corporation has a separate bank account on October 31, 1974, and on each succeeding day of that taxable year.

(Secs. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

[T.D. 7323, 39 FR 34403, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20654, May 20, 1976; 41 FR 22267, June 2, 1976; T.D. 7747, 45 FR 86459, Dec. 31, 1980]

EFFECTIVE DATE NOTE: At 45 FR 86459, Dec. 31, 1980, § 1.922-1(d)(2)(i) (*a*) and (*b*) were amended, effective Apr. 30, 1981. For the convenience of the user, the superseded text is set forth below:

§ 1.992-1 Requirements of a DISC.

* * * * *

(*a*) Would qualify as debt for purposes of the Code if the DISC were a corporation which did not qualify as a DISC,

(*b*) Qualifies under subdivision (ii) of this subparagraph, or

§ 1.992-2 Election to be treated as a DISC.

(a) *Manner and time of election*—(1) *Manner*—(i) *In general.* A corporation can elect to be treated as a DISC for a taxable year beginning after December 31, 1971. Except as provided in paragraph (a)(1)(ii) of this section, the election is made by the corporation filing Form 4876 with the service center with which it would file its income tax return if it were subject for such taxable year to all the taxes imposed by subtitle A of the Internal Revenue Code of 1954. The form shall be signed by any person authorized to sign a corporation return under section 6062, and shall contain the information required by such form. Except as provided in paragraphs (b)(3) and (c) of this section, such election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to such Form 4876 when filed with the service center.

(ii) *Transitional rule for corporations electing during 1972.* If the first taxable year for which an election by a corporation to be treated as a DISC is a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election may be made either in the manner prescribed in subdivision (i) of this subparagraph or by filing, at the place prescribed in subdivision (i) of this subparagraph, a statement captioned "Election to be Treated as a DISC." Such statement of election shall be valid only if the consent of each shareholder is filed with the service center in the form, and at the time, prescribed in paragraph (b) of this section. Such statement shall be signed by any person authorized to sign a corporation return under section 6062 and shall include the name, address, and employer identification number (if known) of the corporation, the beginning date of the first taxable year for which the election is effective, the number of shares of stock of the corporation issued and outstanding as of the earlier of the beginning of the first taxable year for which the election is effective or the time the statement is filed, the number of shares held by each shareholder as of the earlier of such dates, and the date and place of incorporation. As a condition of the election being effective, a corporation which elects to become a DISC by filing a statement in accordance with this subdivision must furnish (to the service center with which the statement was filed) such additional information as is required by Form 4876 by March 31, 1973.

(2) *Time of making election*—(i) *In general.* In the case of a corporation making an election to be treated as a DISC for its first taxable year, such election shall be made within 90 days after the beginning of such taxable year. In the case of a corporation which makes an election to be treated as a DISC for any taxable year beginning after March 31, 1972 (other than the first taxable year of such corporation), the election shall be made during the 90-day period immediately preceding the first day of such taxable year.

(ii) *Transitional rules for certain corporations electing during 1972.* In the case of a corporation which makes an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before March 31, 1972 (other than its first taxable year), the election shall be made within 90 days after the beginning of such taxable year.

(b) *Consent by shareholders*—(1) *In general*—(i) *Time and manner of consent.* Under paragraph (a)(1)(i) of this section, subject to certain exceptions, the election to be treated as a DISC is not valid unless each person who is a shareholder as of the beginning of the first taxable year for which the election is effective signs either the statement of consent on Form 4876 or a separate statement of consent attached to such form. A shareholder's consent is binding on such shareholder and all transferees of his shares and may not be withdrawn after a valid election is made by the corporation. In the case of a corporation which files an election to become a DISC for a taxable year beginning after December 31, 1972, if a person who is a shareholder as of the beginning of the first taxable year for which the election is effective does not consent by signing the statement of consent set forth on Form 4876, such election shall be valid (except in the case of an extension of the time for filing granted under the provisions of subparagraph (3) of this paragraph or paragraph (c) of this section) only if the consent of such shareholder is attached to the Form 4876 upon which such election is made.

(ii) *Form of consent.* A consent other than the statement of consent set forth on Form 4876 shall be in the form of a statement which is signed by the shareholder and which sets forth (*a*) the name and address of the corporation and of the shareholder and (*b*) the number of shares held by each such shareholder as of the time the consent is made and (if the consent is made after the beginning of the corporation's taxable year for which the election is effective) as of the beginning of such year. If the consent is made by a recipient of transferred shares pursuant to paragraph (c) of this section, the statement of consent shall also set forth the name and address of the person who held such shares as of the beginning of such taxable year and the number of such shares. Consent shall be made in the following form: "I (insert name of shareholder), a shareholder of (insert name of corporation seeking to make the election) consent to the election of (insert name of corporation seeking to make the election) to be treated as a DISC under section 992(b) of the Internal Revenue Code. The consent so made by me is irrevocable and is binding upon all transferees of my shares in (insert name of corporation seeking to make the election)." The consents of all shareholders may be incorporated in one statement.

(iii) *Who may consent.* Where stock of the corporation is owned by a husband and wife as community property (or the income from such stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock or the income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. The consent of a minor shall be made by his legal guardian or by his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The consent of a trust shall be made by the trustee thereof. The consent of an estate or trust having more than one executor, administrator, or trustee, may be made by any executor, administrator, or trustee, authorized to make a return of such estate or trust pursuant to section 6012(b)(5). The consent of a corporation or partnership shall be made by an officer or partner authorized pursuant to section 6062 or 6063, as the case may be, to sign the return of such corporation or partnership. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under sections 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.

(2) *Transitional rule for corporations electing during 1972.* In the case of a corporation which files an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election shall be valid only if the consent of each person who is a shareholder as of the beginning of the first taxable year for which such election is effective is filed with the service center with which the election was filed within 90 days after the first day of such taxable year or within the time granted for an extension of time for filing such consent. The form of such consent shall be the same as that prescribed in subparagraph (1) of this paragraph. Such consent shall be attached to the statement of election or shall be filed separately (with such service center) with a copy of the statement of election. An extension of time for filing a consent may be granted in the manner, and subject to the conditions, described in subparagraph (3) of this paragraph.

(3) *Extension of time to consent.* An election which is timely filed and would be valid except for the failure to attach the consent of any shareholder to the Form 4876 upon which the election was made or to comply with the 90-day requirement in subparagraph (2) of this paragraph or paragraph (c)(1) of this section, as the case may be, will not be invalid for such reason if it is shown to the satisfaction of the service center that there was reasonable cause for the failure to file such consent, and if such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service. In the case of a late filing of a consent, a copy of the Form 4876 or statement of election shall be attached to such consent and shall be filed with the same service center as the election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. In no event can any consent be made pursuant to this paragraph on or after the last day of the first taxable year for which a corporation elects to be treated as a DISC.

(c) *Consent by holder of transferred shares*—(1) *In general.* If a shareholder of a corporation transfers—

(i) Prior to the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him without having consented to such election, or

(ii) On or before the 90th day after the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him as of the first day of such year (or if later, held by him as of the time such shares are issued) without having consented to such election, then consent may be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, an extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of this section. In addition, if the transfer occurs more than 90 days after the first day of such taxable year, an extension of time for filing such consent may be granted to such recipient only if it is determined under paragraph (b)(3) of this section that an extension of time would have been granted the transferor for the filing of such consent if the transfer had not occurred. A consent which is not attached to the original Form 4876 or statement of election (as the case may be) shall be filed with the same service center as the original Form 4876 or statement of election and shall have attached a copy of such original form or statement of election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. For the purposes of this paragraph, a transfer of shares includes any sale, exchange, or other disposition, including a transfer by gift or at death.

(2) *Requirement for the filing of an amended Form 4876 or statement of election.* In any case in which a consent to a corporation's election to be treated as a DISC is made pursuant to subparagraph (1) of this paragraph, such corporation must file an amended Form 4876 or statement of election (as the case may be) reflecting all changes in ownership of shares. Such form must be filed with the same service center with which the original Form 4876 or statement of election was filed by such corporation.

(d) *Effect of election*—(1) *Effect on corporation.* A valid election to be treated as a DISC remains in effect (without regard to whether the electing corporation qualifies as a DISC for a particular year) until terminated by any of the methods provided in paragraph (e) of this section. While such election is in effect, the electing corporation is subject to sections 991 through 997 and other provisions of the Code applicable to DISC's for any taxable year for which it qualifies as a DISC (or is treated as qualifying as a DISC pursuant to § 1.992-1(g)). Such corporation is also subject to such provisions for any taxable year for which it is treated as a former DISC as a result of qualifying or being treated as a DISC for any taxable year for which such election was in effect.

(2) *Effect on shareholders.* A valid election by a corporation to be treated as a DISC subjects the shareholders of such corporation to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the Code relating to the shareholders of a DISC or former DISC. Such provisions of the Code apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

(e) *Termination of election*—(1) *In general.* An election to be treated as a DISC is terminated only as provided in subparagraph (2) or (3) of this paragraph.

(2) *Revocation of election*—(i) *Manner of revocation.* An election by a corporation to be treated as a DISC may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation filing a statement that the corporation revokes its election under section 992(b) to be treated as a DISC. Such statement shall indicate the corpora-

tion's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporation return under section 6062. Such revocation shall be filed with the service center with which the corporation filed its election, except that, if it filed an annual information return under section 6011(e)(2), the revocation shall be filed with the service center with which it filed its last such return.

(ii) *Years for which revocation is effective.* If a corporation files a statement revoking its election to be treated as a DISC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a DISC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

(3) *Continued failure to be a DISC.* If a corporation which has elected to be treated as a DISC does not qualify as a DISC (and is not treated as a DISC pursuant to § 1.992-1(g)) for each of any 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically, without notice to such corporation or to the Internal Revenue Service. If, during any 5-year period for which an election is effective, the corporation should qualify as a DISC (or be treated as a DISC pursuant to § 1.992-1(g)) for a taxable year, a new 5-year period shall automatically start at the beginning of the following taxable year.

(4) *Election after termination.* If a corporation has made a valid election to be treated as a DISC and such election terminates in either manner described in subparagraph (2) or (3) of this paragraph, such corporation is eligible to reelect to be treated as a DISC at any time by following the procedures described in paragraphs (a) through (c) of this section. If a corporation terminates its election and subsequently reelects to be treated as a DISC, the corporation and its shareholders continue to be subject to sections 995 and 996 with respect to the period during which its first election was in effect. Thus, for example, distributions upon disqualification includible in the gross incomes of shareholders of a corporation pursuant to section 995(b)(2) continue to be so includible for taxable years for which a second election of such corporation is in effect without regard to the second election.

[T.D. 7323, 39 FR 34405, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976]

§ 1.992-3 Deficiency distributions to meet qualification requirements.

(a) *In general.* A corporation which meets the requirements described in § 1.992-1 for treatment as a DISC for a taxable year, other than the 95 percent of gross receipts test described in § 1.992-1(b) or the 95-percent assets test described in § 1.992-1(c), or both tests, may nevertheless qualify as a DISC for such year by making deficiency distributions (attributable to its gross receipts other than qualified export receipts and its assets other than qualified export assets) if all of the following requirements are satisfied:

(1) The corporation distributes the amount determined under paragraph (b) of this section as a deficiency distribution. The amount of a deficiency distribution is determined without regard to the amount by which the corporation fails to meet either test.

(2) The reasonable cause requirements prescribed in paragraph (c)(1) of this section are satisfied with respect to both the corporation's failure to meet either test and its failure to make a deficiency distribution prior to the time the distribution is made.

(3) The corporation makes such deficiency distribution pro rata to all its shareholders.

(4) The corporation designates the distribution, at the time of the distribution, as a deficiency distribution, pursuant to section 992(c), to meet the qualification requirements to be a DISC. Such designation shall be in the

form of a communication sent at the time of such distribution to each shareholder and to the service center with which the corporation has filed or will file its return for the taxable year to which the distribution relates. A corporation may not retroactively designate a prior distribution as a deficiency distribution to meet qualification requirements. Subject to the limitation described in paragraph (c)(3) of this section, a corporation may make a deficiency distribution with respect to a taxable year at any time after the close of such taxable year or, in the case of a deficiency distribution made on or before September 29, 1975, at any time during or after such taxable year.

See sections 246(d), 904(f), 995, and 996 for rules regarding the treatment of a deficiency distribution to meet qualification requirements by the shareholders and the corporation.

(b) *Amount of deficiency distribution*—(1) *In general.* In order to meet the requirements of paragraph (a) of this section, the amount of a deficiency distribution must be, if the corporation fails to meet—

(i) The 95 percent of gross receipts test, the amount determined in subparagraph (2) of this paragraph,

(ii) The 95-percent assets test, the amount determined in subparagraph (3) of this paragraph, and

(iii) Both such tests, except as provided in subparagraph (4) of this paragraph, the sum of the amounts determined in subparagraphs (2) and (3) of this paragraph.

(2) *Computation of deficiency distribution to meet 95 percent of gross receipts test.*—(i) *In general.* If a corporation fails to meet the 95 percent of gross receipts test described in § 1.992-1(b) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the sum of its taxable income (if any) from each transaction giving rise to gross receipts (as defined in § 1.993-6) which are not qualified export receipts (as defined in § 1.993-1). A corporation's taxable income from a transaction shall be the amount of such gross receipts from such transaction reduced only by (*a*) its cost of goods sold attributable to such gross receipts, and by (*b*) its expenses, losses, and other deductions properly apportioned or allocated thereto in a manner consistent with the rules set forth in § 1.861-8. For purposes of this subdivision, however, any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income in such manner shall not reduce such gross receipts. If the corporation is a commission agent for a principal in a transaction, the corporation's taxable income is the amount of the commission from such transaction reduced only by the amounts described in (*b*) of this subdivision.

(ii) *Example.* The provisions of this subparagraph may be illustrated by the following example:

Example. (*a*) X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, which seeks to qualify as a DISC for 1973. During 1973, X manufactures a machine which is eligible to be export property as defined in § 1.993-3. Y enters into a written supplier's agreement with X, whereby Y is made a commission agent with respect to exporting such machine, which satisfies the requirements of § 1.993-1(1). Under the supplier's agreement, Y is to receive a commission. Thereafter, during 1973 Y is considered to receive gross receipts of $100,000, as determined under section 993(f), attributable to X's sale of the machine in a manner which causes the gross receipts to be excluded receipts pursuant to section 993(a)(2) and, therefore, not qualified export receipts. Y's total gross receipts for 1973 are $1 million of which $900,000 (*i.e.,* 90 percent) are qualified export receipts. Therefore, Y does not satisfy the 95 percent of gross receipts test for 1973 because less than 95 percent of its gross receipts are qualified export receipts. Y has $9,000 of expenses properly apportioned or allocated to its gross income from such sale and $1,000 of other expenses which cannot definitely be allocated to some item or class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8. In order to satisfy the 95 percent of gross receipts test for 1973, if the commission due from X to Y under the supplier's agreement of the parties were $15,000, Y must make a deficiency distribution of $6,000 computed as follows:

Y's commission (gross income) from the transaction	$15,000
Less: Y's expenses apportioned or allocated to its gross income from the transaction	9,000

Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts	6,000

(*b*) If the commission due from X to Y under the supplier's agreement of the parties were $9,400, resulting in a net loss of $600 to Y ($9,400 to $10,000), Y must make a deficiency distribution of $400 computed as follows:

Y's commissions (gross income) from the transaction	$9,400
Less: Y's expenses apportioned or allocated to its gross income from the transaction	9,000
Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts	400

(*c*) If the commission due from X to Y under the commission agreement of the parties were $8,500, Y would not be required to make a deficiency distribution since, under this subparagraph, there would be no taxable income attributable to gross receipts from the sale.

(3) *Computation of deficiency distribution to meet 95 percent assets test*—(i) *In general.* If a corporation fails to meet the 95 percent assets test described in § 1.992-1(c) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the fair market value as of the last day of such taxable year of the assets which are not qualified export assets held by such corporation on such last day.

(ii) *Asset held for more than 1 year.* In the case of a corporation which holds continuously an asset which is not a qualified export asset at the close of more than 1 taxable year, it must distribute an amount equal to its fair market value (or, if greater, the amount determined under subparagraph (4) of this paragraph) only once if, at the close of the first such taxable year, such corporation reasonably believed that such asset was a qualified export asset. This subdivision shall not apply for any taxable year beginning after the date the corporation knows (or a reasonable man would have known) that an asset is not a qualified export asset and in order to qualify for each such year, the corporation must distribute the fair market value of such asset for each such year.

(4) *Computation in the case of a failure to meet both tests as a result of a single transaction.* If a corporation fails to meet both the 95 percent of gross receipts test and the 95 percent assets test for a taxable year, and if the corporation holds at the end of such year assets (other than cash or qualified export assets) which were received as proceeds of a sale or exchange during such year which resulted in gross receipts other than qualified export receipts, then the amount of the deficiency distribution required by this paragraph with respect to such sale or exchange and assets held is the larger of the amount required by subparagraph (2) of this paragraph with respect to the sale or exchange or the amount required by subparagraph (3) of this paragraph with respect to such assets held. Thus, for example, if a corporation sells property which is not a qualified export asset for $100, receives $85 in cash and a note for $15, and derives $25 of taxable income from the sale as determined under subparagraph (2) of this paragraph, it must distribute $25. If the provisions of this subparagraph are applied with respect to assets of a DISC (other than qualified export assets), such provisions do not apply to any property received as proceeds from a sale or exchange of such assets.

(c) *Reasonable cause for failure*—(1) *In general.* If for a taxable year, a corporation has failed to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests, such corporation may satisfy any such test for such year by means of a deficiency distribution in the amount determined under paragraph (b) of this section only if the reasonable cause requirements of this subparagraph are satisfied. Such reasonable cause requirements are satisfied if—

(i) There is reasonable cause (as determined in accordance with subparagraph (2) of this paragraph) for such corporation's failure to satisfy such test and to make such distribution prior to the date on which it was made, the time limit in subparagraph (3) of this paragraph for making the distribution is satisfied, and interest (if required) is paid in the amount and in the manner prescribed by subparagraph (4) of this paragraph, or

(ii) The time and "70-percent" requirements of the reasonable cause test of paragraph (d) of this section are satisfied.

(2) *Determination of reasonable cause.* In general, whether a corporation's failure to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests for a taxable year and its failure to make a pro rata distribution prior to the date on which it was made will be considered for reasonable cause where the action or inaction which resulted in such failure occurred in good faith, such as failure to meet the 95 percent assets test resulting from blocked currency or expropriation, or failure to meet either test because of reasonable uncertainty as to what constitutes a qualified export receipt or a qualified export asset. For further examples, if a corporation's reasonable determination of the percentage of its total gross receipts that are qualified export receipts is subsequently redetermined to be less than 95 percent as a result of a price adjustment by the Internal Revenue Service under section 482, or if the corporation has a casualty loss for which it receives an unanticipated insurance recovery which causes its qualified export receipts to be less than 95 percent of its total gross receipts, then the failure to satisfy the 95 percent of gross receipts test is considered to be due to reasonable cause.

(3) *Time limit for deficiency distribution.* Except as otherwise provided in this subparagraph, the time limit prescribed by this subparagraph for making a deficiency distribution is satisfied if the amount of the distribution required by paragraph (b) of this section is made within 90 days from the date of the first written notification to the corporation by the Internal Revenue Service that it had not satisfied the 95 percent of gross receipts test or the 95 percent assets test or both tests, for a taxable year. Upon a showing by the corporation that an extension of the 90-day time limit is reasonable and necessary, the Commissioner may grant such extension of such time limit. In any case in which a corporation contests the decision of the Internal Revenue Service that such corporation has not met the 95 percent of gross receipts test, the 95 percent assets test, or both tests, an extension of the 90-day time limit will be allowed until 30 days after the final determination of such contest. The date of the final determination of such contest shall, for purposes of section 992(c), be established in the manner specified in subdivisions (i) through (iv) of this subparagraph:

(i) The date of final determination by a decision of the United States Tax Court is the date upon which such decision becomes final, as prescribed in section 7481.

(ii) The date of final determination in a case which is contested in a court (and upon which there is a judgment) other than the Tax Court is the date upon which the judgment becomes final and will be determined on the basis of the facts and circumstances of each particular case. For example, ordinarily a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iii) The date of a final determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(iv) A final determination under section 992(c) may be made by an agreement signed by the district director or director of the service center with which the corporation files its annual return or by such other official to which authority to sign has been delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the deficiency distribution to be paid to the shareholders of the DISC for the taxable year or years. An agreement under this subdivision shall be sent to the taxpayer at his last known address by either registered or certified mail. If registered mail is used for such purpose, the date of registration is considered the date of final determination; if certified mail is used for such purpose, the date of postmark on the sender's receipt for such mail is considered the date of final determination. If the corporation makes a deficiency distribution before such registration or postmark date but on or after the date the district director or director of the service center or other official has signed the agreement, the date of signature by the district director or director of the service center or other official is considered the date of final determination. If the corporation makes a deficiency distribution before the district director or director of the service center or other official signs the agreement, the date of final determination is considered to be the date of the making of the deficiency distribution. During any extension of time the interest charge provided in subparagraph (4) of this paragraph will continue to accrue at the rate provided for in such subparagraph.

(4) *Payment of interest for delayed distribution*—(i) *In general.* If a corporation makes a deficiency distribution after the 15th day of the ninth month after the close of the taxable year with respect to which such distribution is made, such distribution will not be deemed to satisfy the 95 percent of gross receipts test or the 95 percent assets test for such year unless such corporation pays to the Internal Revenue Service a charge determined by multiplying (a) an amount equal to 4½ percent of such distribution by (*b*) the number of its taxable years which begin (*1*) after the taxable year with respect to which the distribution is made and (*2*) before such distribution is made. Such charge must be paid, within the 30-day period beginning with the day on which such distribution is made, to the service center with which the corporation files its annual information return for its taxable year in which the distribution is made. For purposes of the Internal Revenue Code, such charge is considered interest.

(ii) *Example.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. X corporation, which uses the calendar year as its taxable year, meets the 95 percent assets test but fails to meet the 95 percent of gross receipts test for 1972 and does not by September 15, 1973, make the deficiency distribution required by reason of its failure to meet such test. Assume that reasonable cause exists for the corporation's failure to meet the 95 percent of gross receipts test and failure to make the required deficiency distribution. If X makes the required deficiency distribution, in the amount of $10,000, on April 1, 1976, X must pay on or before April 30, 1976, to the service center with which it files its annual information return a charge of $1,800, computed as follows:

Deficiency distribution made by X	$10,000
Multiplied by 41/2 percent	.045
Intermediate product	450
Multiplied by: Number of X's taxable years beginning after 1972 and before April 1, 1976	4
Charge to be paid service center because of late deficiency distribution (which is considered interest)	1,800

(d) *Certain distributions deemed for reasonable cause.* If a corporation makes a distribution in the amount required by paragraph (b) of this section with respect to a taxable year on or before the 15th day of the ninth month after the close of such year, it will be deemed to have acted with reasonable cause with respect to its failure to satisfy the 95 percent of gross receipts test, the 95 percent assets test, or both tests, for such year and its failure to make such distribution prior to the date on which the distribution was made if—

(1) At least 70 percent of the gross receipts of such corporation for such taxable year consist of qualified export receipts, and

(2) The sum of the adjusted bases of the qualified export assets held by such corporation on the last day of each month of the taxable year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such day.

[T.D. 7323, 39 FR 34407, Sept. 25, 1974; 39 FR 36009, Oct. 7, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976]

§ 1.992-4 Coordination with personal holding company provisions in case of certain produced film rents.

(a) *In general.* Section 992(d)(2) provides that a personal holding company is not eligible to be treated as a DISC. Section 543(a)(5)(B) provides that, for purposes of section 543, the term "produced film rents" means payments received with respect to an interest in a film for the use of, or the right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. Under section 992(e), if such produced film rents are included in the ordinary gross income (as defined in section 543(b)(1)) of a qualified subsidiary for a taxable year of such subsidiary, and such interest was acquired by such subsidiary from its parent, such interest is deemed (for purposes of the application of sections 541, 543(b)(1), and 992(d)(2), and § 1.992-1(f) for such taxable year) to have been acquired by such subsidiary at the time such interest was acquired by such parent. Thus, for example, if a parent acquires an interest in a film before it is substantially completed, then substantially completes such film prior to transferring an interest in such motion picture to a qualified subsidiary, the qualified subsidiary is considered as having acquired such interest prior to substantial completion of such motion picture for purposes of determining whether payments from the rental of such motion picture will be classified as produced film rents of such subsidiary. The provisions of section 992(e) and this section are not applicable in determining whether payments received with respect to an interest in a film are included in the ordinary gross income of a parent or a qualified subsidiary. Thus, even though a qualified subsidiary is treated pursuant to this section as having acquired an interest in a film at the time such interest was acquired by such subsidiary's parent, payments received by such parent with respect to such interest prior to the transfer of such interest to such subsidiary are includible in the ordinary gross income of such parent and not includible in the ordinary gross income of such subsidiary.

(b) *Definitions*—(1) *"Qualified subsidiary"*. For purposes of this section, a corporation is a qualified subsidiary for a taxable year if—

(i) Such corporation was established for the purpose of becoming a DISC,

(ii) Such corporation would qualify (or be treated) as a DISC for such taxable year if it is not a personal holding company, and

(iii) On every day of such taxable year on which shares of such corporation are outstanding, at least 80 percent of such shares are held directly by a second corporation.

(2) *"Parent"*. For purposes of this section, the term "parent" means a second corporation referred to in subparagraph (1)(iii) of this paragraph.

[T.D. 7323, 39 FR 34409, Sept. 25, 1974]

§ 1.993-1 Definition of qualified export receipts.

(a) *In general.* For a corporation to qualify as a DISC, at least 95 percent of its gross receipts for a taxable year must consist of qualified export receipts. Under section 993(a), the term "qualified export receipts" means any of the eight amounts described in paragraphs (b) through (i) of this section, except to the extent that any of the eight amounts is an excluded receipt within the meaning of paragraph (j) of this section. For purposes of this section and §§ 1.993-2 through 1.993-6—

(1) *DISC.* All references to a DISC mean a DISC, except when the context indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a DISC, or a corporation being tested as to whether it qualifies as a DISC.

(2) *Sale, lease, and license.* The term "sale" includes an exchange or other disposition and the term "lease" includes a rental or a sublease. The term "license" includes a sublicense. All rules under this section and §§ 1.993-2 through 1.993-6 applicable to leases of export property apply in the same manner to licenses of export property. See § 1.993-3(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts.* The term "gross receipts" is defined by section 993(f) and § 1.993-6.

(4) *Qualified export assets.* The term "qualified export assests" is defined by section 993(b) and § 1.993-2.

(5) *Export property.* The term "export property" is defined by section 993(c) and § 1.993-3.

(6) *Related person.* The term "related person" means a person who is related to another person if either immediately before or after a transaction—

(i) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers), or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships), and the regulations thereunder, or

(ii) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that (*a*) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a) and the regulations thereunder, and (*b*) the provisions of section 1563(b) shall not apply in determining whether such persons are members of the same controlled group.

(7) *Related supplier.* The term "related supplier" is defined by § 1.994-1 (a) (3) (ii).

(8) *Controlled group.* The term "controlled group" is defined by paragraph (k) of this section.

(b) *Sales of export property.* Qualified export receipts of a DISC include gross receipts from the sale of export property by such DISC, or by any principal for whom such DISC acts as a commission agent (whether or not such principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by such DISC or by such principal at any time or by any other person and assigned to such DISC or such principal at any time prior to the shipment of such property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirement of this paragraph, but see paragraph (l) (1) of this section for the requirement of a written supplier's agreement between the DISC and its related supplier. Gross receipts from the sale of export property, whenever received, do not constitute qualified export receipts unless the seller (or the corporation acting as commission agent for the seller) is a DISC at the time of the shipment of such property to the purchaser. For example, if a corporation which sells export property under the installment method is not a DISC for the taxable year in which the property is shipped to the purchaser, gross receipts from such sale do not constitute qualified export receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from the lease of export property provided that—

(i) Such property is held by such DISC (or by a principal for whom such DISC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of such lease, and

(ii) Such DISC qualified (or was treated) as a DISC for its taxable year in which the term of such lease began.

(2) *Prepayment of lease receipts.* If part or all of the gross receipts from a lease of property are prepaid, then—

(i) All such prepaid gross receipts are qualified export receipts of a DISC if it is reasonably expected at the time of such prepayment that throughout the term of such lease they would be qualified export receipts if received not as a prepayment; or

(ii) If it is reasonably expected at the time of such prepayment that throughout the term of such lease they would not be qualified export receipts if received not as a prepayment, then only those prepaid receipts, for the taxable years of the DISC for which they would be qualified export receipts, are qualified export receipts.

Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered qualified export receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered qualified export receipts.

(d) *Related and subsidiary services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from services furnished by such DISC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by such DISC or with respect to which such DISC acts as a commission agent, provided that such DISC derives qualified export receipts from such sale or lease. Such services may be performed within or without the United States.

(2) *Services furnished by DISC.* Services are considered to be furnished by a DISC for purposes of this paragraph if such services are provided by—

(i) The person who sold or lease the export property to which such services are related and subsidiary, provided that the DISC acts as a commission agent with respect to the sale or lease of such property and with respect to such services.

(ii) The DISC as principal, or any other person pursuant to a contract between such person and such DISC, provided the DISC acted as principal or commission agent with respect to the sale or lease of such property, or

(iii) A member of the same controlled group as the DISC where the sale or lease of the export property is made by another member of such controlled group provided, however, that the DISC act as principal or commission agent with respect to such sale or lease and as commission agent with respect to such services.

(3) *Related services.* A service is related to a sale or lease of export property if—

(i) Such service is of the type customarily and usually furnished with the type of transaction in the trade or business in which such sale or lease arose and

(ii) The contract to furnish such service—

(*a*) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(*b*) Is entered into on or before the date which is 2 years after the date on which the contract under which such sale or lease was entered into, provided that the person described in subparagraph (2) of this paragraph which is to furnish such service delivers to the purchaser or lessor a written offer or option to furnish such services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(*c*) Is a renewal of the services contract described in (*a*) or (*b*) of this subdivision. Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) may be related to a sale or lease of export property, provided that the cost of such transportation is included in the sale price or rental of the property or, if such cost is separately stated, is paid by the DISC (or its principal) which sold or leased the property to the person furnishing the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to such sale or lease only if it is reasonably expected at the time of such sale or lease that the gross receipts from all related services furnished by the DISC (as defined in subparagraphs (2) and (3) of this paragraph) will not exceed 50 percent of the sum of (a) the gross receipts from such sale or lease and (b) the gross receipts from related services furnished by the DISC (as described in subparagraph (2) of this paragraph). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the 10-year period following the date of such-sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the term of such lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the services related to a sale or lease of export property are subsidiary to such sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to such services as determined under the facts and circumstances of each case without regard to whether—

(*a*) Such services are furnished under a separate contract or under the same contract pursuant to which such sale or lease occurs or

(*b*) The cost of such services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from such transaction and the total gross receipts from all services related to such transaction are each taken into account in determining whether such services are subsidiary to such transaction. However, the provisions of this subdivision apply only if such items could be included in the same product line, as determined under § 1.994-1(c)(7).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, such contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to such sale or lease if it is reasonably expected at the time of such renewal that the gross receipts from all related services which have been and which are to be furnished by the DISC (as described in subparagraph (2) of this paragraph) will not exceed 50 percent of the sum of (*a*) the gross receipts from such sale or lease and (*b*) the gross receipts from related services furnished by the DISC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this subparagraph.

(v) *Parts used in services.* In a services contract described in subparagraph (3) of this paragraph provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of such parts are not taken into account in determining whether under this subparagraph the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts consitute qualified export receipts. See § 1.993-3(c)(2)(iv) and (e)(3) for rules regarding the treatment of such parts with respect to the manufacture of export property and the foreign content of such property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all such services which are to be performed before the end of the term of such lease, then as of the time of the prepayment the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this subdivision are qualified export receipts. Thus, for example if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be qualified export receipts. However, any prepaid gross receipts for such services to be furnished in the second year cannot be qualified export receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute qualified export receipts does not depend upon whether services connected with such sale or lease are related and subsidiary to such sale or lease. Thus, for example, assume that a DISC receives gross receipts of $1,000 from the sale of export property and gross, receipts of $1,100 from installation and maintenance services which are to be furnished by such DISC within 10 years after the sale and which are related to such sale. The $1,100 which the DISC receives for such services would not be qualified export receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts

from the related services furnished by such DISC. The $1,000 which the DISC receives from the sale of export property would, however, be a qualified export receipt if the sale met the requirements of paragraph (b) of this section.

(e) *Gains from sales of certain qualified export assets.* Qualified export receipts of a DISC include gross receipts from the sale by such DISC of any assets (wherever located) which, as of the date of such sale, are qualified export assets as defined in § 1.993-2 even though such assets are not export property (as defined in § 1.993-3). Gross receipts are derived from the sale of such assets only where such sale results in recognized gain (see § 1.993-6(a)). For purposes of this paragraph, losses from the sale of such qualified export assets shall not be taken into account for purposes of determining the DISC's qualified export receipts.

(f) *Dividends.* Qualified export receipts of a DISC for a taxable year include all dividends includible in the gross income of such DISC for such taxable year with respect to the stock of related foreign export corporations (as defined in § 1.993-5) and all amounts includible in the gross income of such DISC with respect to such corporations pursuant to section 951 (relating to amounts included in the gross income of U.S. shareholders of controlled foreign corporations).

(g) *Interest on obligations which are qualified export assets.* Qualified export receipts of a DISC include interest on any obligation which is a qualified export asset of such DISC, including any amount includible in gross income as interest (such as, for example, an amount treated as original issue discount pursuant to section 1232) or as imputed interest under section 483. Gain from the sale of obligations described in this paragraph is treated (to the extent such gain is not treated as interest on such obligations) as qualified export receipts pursuant to paragraph (e) of this section.

(h) *Engineering and architectural services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from engineering services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (6) of this paragraph) furnished by such DISC (as described in subparagraph (7) of this paragraph) for a construction project (as defined in subparagraph (8) of this paragraph) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for minerals or

(ii) Technical assistance or know-how.

For purposes of this paragraph, the term "technical assistance or know-how" includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute qualified export receipts to the extent that such activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of subparagraph (8) of this paragraph) include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to such professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic, and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of subparagraph (8) of this paragraph).

(7) *Definition of "furnished by such DISC".* For purposes of this paragraph, architectural and engineering services are considered furnished by a DISC if such services are provided—

(i) By the DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the DISC at any time prior to the furnishing of such services, provided that the DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services and provided further that such contract between a DISC and a related supplier (as defined in § 1.994-1 (a) (3)) qualifies as a supplier's agreement under § 1.993-1(l) (1).

(8) *Definition of "construction project".* For purposes of this paragraph, the term "construction project" includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad, tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not qualified export receipts unless such equipment is export property (as defined in § 1.993-3).

(i) *Managerial services*—(1) *In general.* Qualified export receipts of a first DISC for its taxable year include gross receipts from the furnishing of managerial services provided for another DISC, which is not a related person, to aid such unrelated DISC in deriving qualified export receipts, provided that at least 50 percent of the gross receipts of the first DISC for such year consists of qualified export receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services, as described in paragraph (b), (c), and (d) of this section, respectively.

For purposes of this paragraph, managerial services are considered furnished by a DISC if such services are provided—

(i) By the first DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the first DISC at any time prior to the furnishing of such services, provided that the first DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such service and provided further that such contract between a DISC and a related supplier (as defined in § 1.994-1(a)(3)) qualifies as a supplier's agreement under § 1.993-1(l)(1).

(2) *Definition of "managerial services."* The term "managerial services" as used in this paragraph means activities relating to the operation of another unrelated DISC which derives qualified export receipts from the sale or lease of export property and from the furnishing of services related and subsidiary to such sales or leases. Such term includes staffing and operational services necessary to operate such other DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: (i) Export market studies, (ii) making shipping arrangements, and (iii) contracting potential foreign purchasers.

(3) *Status of recipient of managerial services*—(i) *In general.* Qualified export receipts of a first DISC include receipts from the furnishing of managerial services during any taxable year of a recipient if such recipient qualifies as a DISC (within the meaning of § 1.992-1(a) for such taxable year.

(ii) *Recipient deemed to qualify as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient is deemed to qualify as a DISC for its taxable year if the first DISC obtains from such recipient a copy of such recipient's election to be treated as a DISC as described in § 1.992-2(a) together with such recipient's sworn statement that such election has been filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a DISC before submitting it to the first DISC. The copy of the election and the sworn statement of such recipient must be received by the first DISC within 6 months after the beginning of the first taxable year of the recipient during which such first DISC furnishes managerial services for such recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first DISC for subsequent taxable years of the recipient.

(iii) *Recipient not treated as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient of managerial services is not treated as a DISC with respect to such services performed during a taxable year for which such recipient does not qualify as a DISC if the DISC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing DISC's managerial relationship with such recipient DISC) at the beginning of such taxable year that the recipient will qualify as a DISC for such taxable year.

(j) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (i) of this section, qualified export receipts of a DISC do not include any of the five amounts described in subparagraphs (2) through (6) of this paragraph.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See § 1.993-3(d)(4) (relating to determination of where the ultimate use of the property occures). Thus, qualified export receipts of a DISC described in paragraph (b) or (c) of this section do not include gross receipts of the DISC from the sale or lease of such property.

(3) *Sales of export property accomplished by subsidy.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b) of this section if the sale of export property (whether or not such property consists of agricultural products) is pursuant to any of the following:

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151), unless the DISC shows to the satisfaction of the district director that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms and from a seller who was not a U.S. person, goods which were substantially identical to such property and which were not manufactured, produced, grown, or extracted (as described in § 1.993-3(c)) in the United States,

(ii) The Public Law 480 program authorized under Title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701-1710),

(iii) For taxable years ending before January 1, 1974, the Barter program of the Commodity Credit Corporation authorized by section 4(h) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714b(h)), and section 303 of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1692) but only if the taxpayer treats such sales as sales giving rise to excluded receipts.

(iv) The Export Payment program of the Commodity Credit Corporation authorized by sections 5(d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)),

(v) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c), and

(vi) For taxable years beginning after November 3, 1972, the Export Sales program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM-4 program provided under 7 CFR 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities, except that for taxable years beginning on or before November 3, 1972, the taxpayer may treat such sales as sales giving rise to excluded receipts.

(4) *Sales or lease of export property and furnishing of engineering or architectural services for use by the United States*—(i) *In general.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b), (c), or (h) of this section if a sale or lease of export property, or the furnishing of engineering or architectural services, is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of engineering or architectural services performed by a U.S. person. For example, a sale by a DISC of export property to the Department of Defense for use outside the United States would not produce qualified export receipts for such DISC if the Department of Defense purchased such property from appropriated funds subject to any provisions of the Armed Services Procurement Regulations (32 CFR Subchapter A, Part 6, Subpart A) or any appropriations act for the Department of Defense for the applicable year which restricts the availability of such appropriated funds to the procurement of items which are grown, reprocessed, reused, or produced in the United States.

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof is such property is sold or leased by a DISC (or by a principal for whom such DISC acts as commission agent) to—

(*a*) A person who is a related person with respect to such DISC or such principal and who sells or leases such property for use by the United States or an instrumentality thereof or

(*b*) A person who is not a related person with repect to such DISC or such principal if, at the time af such sale or lease, there is an agreement or understanding that such property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of such sale or lease that such property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after such sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (i) and (ii) of this subparagraph do not apply in the case of a purchase by the United States or an instrumentality thereof if such purchase is pursuant to—

(*a*) The Foreign Military Sales Act, as amended (22 U.S.C. § 2751 *et seq.*), or a program under which the U.S. Government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or

(*b*) A program (whether bilateral or multi-lateral) under which sales to the U.S. Government are open to international competitive bidding.

(5) *Services.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (d) of this secrtion (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts pursuant to this paragraph.

(6) *Receipts within controlled group*—(i) *In general.* Gross receipts of

a corporation do not constitute qualified export receipts for any taxable year of such corporation if—

(*a*) At the time of the sale, lease, or other transaction resulting in such gross receipts, such corporation and the person from whom such receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group (as defined in paragraph (k) of this section) and

(*b*) Such corporation and such person each qualifies (or is treated under section 992(a)(2)) as a DISC for its taxable year in which its receipts arise.

Thus, for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are DISC's. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a DISC which is a member of the same controlled group as X, and thus will not result in qualified export receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in qualified export receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in qualified export receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party, may, however, constitute qualified export receipts.

(ii) *Leased property.* See § 1.993-3(f)(2) regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(k) *Definition of "controlled group".* For purposes of sections 991 through 996 and the regulations thereunder, the term "controlled group" has the same meaning as is assigned to the term "controlled group of corporations" by section 1563(a), except that (1) the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 881 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph).

(l) *DISC's entitlement to income*—(1) *Application of section 994.* A corporation which meets the requirements of § 1.992-1(a) to be treated as a DISC for a taxable year is entitled to income, and the intercompany pricing rules of section 994(a) (1) or (2) apply, in the case of any transactions described in § 1.994-1(b) between such DISC and its related supplier (as defined in § 1.994-1(a)(3)) provided that the relationship between the DISC and its related supplier is defined by a supplier's agreement. A supplier's agreement must be a written agreement described in subparagraph (2) of this paragraph except that with respect to a transaction described in § 1.994-1(b) entered into before April 9, 1973 a supplier's agreement is the understanding relating to the participation of the DISC in such transaction, provided that such understanding is reduced before April 9, 1973, to a writing executed by the DISC and its related supplier containing the terms of such understanding (whether or not such writing conforms to the requirements of subparagraph (2) of this paragraph and whether or not the transaction was completed before such date). For purposes of this paragraph, such DISC need not have employees or perform any specific function. If the amount received by the DISC under the terms of such agreement is less than the maximum amount permitted under the intercompany pricing rules of section 994, and if the parties by written amendment to the agreement provide for receipts by the DISC in an amount greater than that provided in the original agreement up to the maximum amount, such amendment shall apply (to the extent it so provides) to all transactions of the DISC occurring during or after the taxable year of the DISC in which such amendment is made.

(2) *Written agreement.* A written agreement between a DISC and its related supplier satisfies the requirements of this subparagraph with respect to a transaction if such agreement provides for determination of the price payable by the DISC, or the commission payable to the DISC, with respect to such transaction and if the agreement is executed prior to such transaction (or, in the case of a sale pursuant to a contract assigned to the DISC or its related supplier, as described in paragraph (b) of this section, the agreement is entered into at any time before shipment of property to the purchaser).

(3) *Other transactions.* In the case of a transaction to which the provisions of subparagraph (1) of this paragraph do not apply but from which a DISC derives gross receipts, the income to which the DISC is entitled as a result of the transaction is determined pursuant to the terms of the contract for such transaction and, if applicable, section 482 and the regulations thereunder. For example, assume that a corporation and its wholly-owned DISC have entered into a written supplier's agreement which provides that the DISC will be a commission agent with respect to all transactions which result in qualified export receipts to the DISC, but will not be considered a commission agent with respect to those transactions which do not result in qualified export receipts for such DISC. If a transaction occurs which does not result in qualified export receipts, the income to the DISC will be determined pursuant to the terms of the contract. Thus, the DISC will be treated as having received no gross receipts or income with respect to the transaction. For a further example, suppose the parent corporation has entered into a contract which provides that the DISC will be considered a commission agent with respect to all transactions, and if a transaction occurs which does not result in qualified export receipts to such DISC, then the DISC's entitlement to income will be determined under section 482.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. P enters into a written supplier's agreement (required by subparagraph (1) of this paragraph) with S whereby S is granted a franchise with respect to specified exports of P. P will sell such exports to S for resale by S. Such exports are of a type which produce qualified export receipts as defined in paragraph (b) of this section Under the supplier's agreement, P's sales force will solicit ordrs in the name of S using S's order forms. S places orders with P only when S itself has received orders. No inventory is maintained by S. P makes shipments directly to customers of S. The supplier's agreement also provides that employees of P will act for S and that billings and collections will be handled by P in the name of S. The supplier's agreement provides that S will be entitled to net income on these transactions equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994 of the Code. Under these facts, the income derived by S for such taxable year from the purchase and resale of the specified export is treated for Federal income tax purposes as the income of S, and the amount of income allocable to S will be determined under section 994 of the Code.

Example (2). P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. P enters into a written supplier's agreement (required by subparagraph (1) of this paragraph) with S whereby S is granted a sales franchise with respect to specified exports of P and will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994 of the Code. Such exports are of a type which will produce gross receipts for S which are qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of P. Billings and collections are handled directly by P. Under these facts, the commissions paid to S for such taxable year with respect to the specified exports shall be treated for Federal income tax purposes as the income of S, and the amount of income allocable to S is determined under section 994 of the Code.

[T.D. 7514, 42 FR 55454, Oct. 15, 1977; 42 FR 60910, Nov. 30, 1977]

§ 1.993-2 Definition of qualified export assets.

(a) *In general.* For a corporation to qualify as a DISC, at the close of its taxable year it must have qualified export assets with adjusted bases equal to at least 95 percent of the sum of the adjusted bases of all its assets. An asset which is a qualified export asset under more than one paragraph of this section shall be taken into account only once in determining the sum of the adjusted bases of all qualified export assets. Under section 993(b), the qualified export assets held by a corporation are—

(1) Export property as defined in § 1.993-3 (see paragraph (b) of this section),

(2) Business assets described in paragraph (c) of this section,

(3) Trade receivables described in paragraph (d) of this section,

(4) Temporary investments to the extent described in paragraph (e) of this section,

(5) Producer's loans as defined in § 1.993-4 (see paragraph (f) of this section),

(6) Stock or securities (described in paragraph (g) of this section) of related foreign export corporations as defined in § 1.993-5,

(7) Export-Import Bank and other obligations described in paragraph (h) of this section,

(8) Financing obligations described in paragraph (i) of this section, and

(9) Funds awaiting investment described in paragraph (j) of this section.

(b) *Export property.* In general, export property is certain property held for sale or lease which meets the requirements of § 1.993-3.

(c) *Business assets.* For purposes of this section, business assets are assets used by a DISC (other than as a lessor) primarily in connection with—

(1) The sale, lease, storage, handling, transportation, packaging, assembly, or servicing of export property, or

(2) The performance of engineering or architectural services (described in § 1.993-1(h)) or managerial services (described in § 1.993-1(i)) in furtherance of the production of qualified export receipts. Assets used primarily in the manufacture, production, growth, or extraction (within the meaning of § 1.993-3(c)) of property are not business assets.

(d) *Trade receivables*—(1) *In general.* [Reserved]

(2) *Trade receivables representing commissions.* If a DISC acts as commission agent for a principal in a transaction described in § 1.993-1 (b), (c), (d), (e), (h), or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case of an evidence of indebtedness, designated on its face as representing such commission), such account receivable or evidence of indebtedness shall be treated as a trade receiveable. If, however, the principal is a related supplier (as defined in § 1.994-1(a)(3)) with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(e) (3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively), as the case may be. However, see subparagraph (3) of this paragraph for rules regarding certain accounts receivable representing commissions payable to a DISC by its related supplier.

(3) *Indebtedness arising under § 1.994-1(e).* An indebtedness arising under § 1.994-1(e)(3)(iii) (relating to initial payment of transfer price or commission) in favor of a Disc is not a qualified export asset. An indebtedness arising under § 1.994-1(e)(5)(i) (relating to procedure for adjustments to transfer price or commission) in favor of a DISC is a trade receivable if it is paid in the time and manner described in § 1.994-1(e)(5)(i) and (ii) and if it otherwise satisfies the requirements of subparagraph (2) of this paragraph. If such an indebtedness is not paid in the time and manner described in § 1.994-1(e)(5) (i) and (ii), it is not a qualified export asset.

(e) *Temporary investments*—(1) *In general.* For purposes of this section, temporary investments are money, bank deposits (not including time deposits of more than 1 year), and other similar temporary investments to the extent maintained by a DISC as reasonably necessary to meet its requirements for working capital. For purposes of this paragraph, a temporary investment is an obligation, including an evidence of indebtedness as defined in paragraph (d)(1) of this section, which is a demand obligation or has a period remaining to maturity of not more than 1 year at the date it is acquired by the DISC. A temporary investment does not include trade receivables.

(2) *Determination of amount of working capital maintained.* For purposes of this paragraph—

(i) The working capital of a DISC is the excess of its current assets over current liabilities.

(ii) Current assets are cash and other assets (other than trade receivables) which may reasonably be expected to be converted into cash or sold or consumed during the current normal operating cycle of the DISC's trade or business.

(iii) Current liabilities are obligations (or portions of obligations) due within the current normal operating cycle of the trade or business of the DISC whose satisfaction when due is reasonably expected to require the use of current assets.

(iv) Generally accepted financial accounting treatments will be accepted, and

(v) Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary to meet his current liabilities and its requirements for working capital.

(3) *Determination of amount of working capital reasonably required.* For purposes of this paragraph, a determination of the amount of money, bank deposits, and other similar temporary investments reasonably necessary to meet the requirements of the DISC for working capital will depend upon the nature and volume of the activities of the DISC existing at the end of the DISC's taxable year for which such determination is made, such as, for example—

(i) In the case of a DISC which purchases and sells inventory, the amount of working capital reasonably required is limited to an amount reasonably necessary to meet the ordinary operating expenses during the current normal operating cycle of the trade or business of the DISC, an amount reasonably needed to meet specific and definite plans for expansion and any amounts necessary for reasonably anticipated extraordinary business expenses.

(ii) In the case of a DISC which actively conducts a trade or business (including the employment of a sales force) and receives commissions in respect of goods to which such DISC does not have title, the amount of working capital required will depend upon the nature and volume of the activities of the DISC which produce such income as they exist on the applicable determination date. In determining the amount of working capital which is reasonably required for the production of such income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the DISC following the applicable determination date. Anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of such income as of the applicable determination date.

(iii) In the case of a DISC which does not actively conduct a trade or business, and which receives commissions solely by reason of section 994(a)(1), (a)(2), or (b) with respect to goods to which such DISC does not have title, no working capital would be required beyond a de minimis amount unless it appears from the facts and circumstances that additional working capital will be required.

(iv) In the case of a DISC deriving income from the leasing of property, the amount of working capital required will be determined on the basis of the facts and circumstances in such case.

(4) *Relationship of working capital to other qualified export assets.* If a temporary investment is a qualified export asset under any provision of this section (other than this paragraph), this paragraph shall not affect its status as a qualified export asset. However, any such temporary investment is taken into account before other temporary investments in determining whether such other temporary investments are maintained by a DISC as reasonably necessary to meet its requirements for working capital. Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary requirements for working capital. An obligation issued or incurred by a member of a controlled group (as defined in § 1.993-1(k)) of which the DISC is a member is not a qualified export asset under this paragraph. For rules regarding working capital as of the end of each month of a taxable year for purposes of the 70-percent reasonableness standard with respect to certain deficiency distributions, see paragraph (j)(3) of this section.

(f) *Producer's loans.* For purposes of this section, a producer's loan is an evidence of indebtedness arising in connection with producer's loans which are made by a DISC and which meet the requirements of § 1.993-4.

(g) *Stock or securities of related foreign corporations.* For purposes of this section, the term "stock or securities", with respect to a related foreign export corporation (as defined in § 1.993-5), has the same meaning as such term has as used in section 351 (relating to transfers to controlled corporations), except that the term "securities" does not include obligations which are repaid, in whole or in part, at any time during the taxable year of the DISC following the taxable year of the DISC during which such obligations were acquired by the DISC or were issued, unless the DISC demonstrates to the satisfaction of the district director that the repayment was for bona fide business purposes and not for the purpose of avoidance of Federal income taxes.

(h) *Export-Import Bank obligations*—(1) *In general.* For purposes of this section, subject to the limitations described in subparagraph (2) of this paragraph, the term "Export-Import Bank obligations" means obligations issued, guaranteed, insured, or reinsured (in whole or in part) by the Export-Import Bank of the United States or by the Foreign Credit Insurance Association, but only if such obligations are acquired by the DISC—

(i) From the Export-Import Bank of the United States.

(ii) From the Foreign Credit Insurance Association, or

(iii) From the person selling or purchasing the goods or services by reason of which such obligations arose, or from any corporation which is a member of the same controlled group (as defined in § 1.993-1(k)) as such person.

For purposes of this subparagraph, obligations issued by a person described in subdivisions (i), (ii), and (iii) of this subparagraph are treated as acquired from such person by the DISC if acquired from any person not more than 90 days after the date of original issue (as defined in § 1.1232-3(b)(3)). Examples of specific types of Export-Import Bank obligations include debentures issued by such bank and certificates of loan participation.

(2) *Limitation on Export-Import Bank obligations and financing obligations acquired after November 3, 1972.* Obligations acquired by a DISC after November 3, 1972, and satisfying (without regard to this subparagraph) the requirements of subparagraph (1) of this paragraph or paragraph (i)(1) of this section, will qualify as Export-Import Bank obligations or as financing obligations (as the case may be) only to the extent that, on the applicable determination date described in subparagraph (3) of this paragraph, the sum of the adjusted bases of such obligations (as determined under section 1011) does not exceed the amount of the DISC's accumulated DISC income on that date, reduced by the sum of—

(i) The amount of producer's loans of the DISC outstanding on such date and

(ii) The adjusted bases of obligations held by the DISC on the applicable determination date (other than the ones being tested) which satisfy (without regard to this subparagraph) the requirements of subparagraph (1) of this paragraph or paragraph (i) of this section (including obligations acquired on or before November 3, 1972).

(3) *Applicable determination date.* In determining whether obligations acquired after November 3, 1972, are Export-Import Bank obligations or financing obligations (as the case may be), the DISC may, at its option, compute the amounts of the adjusted bases of obligations, accumulated DISC income, and outstanding producer's loans either at the end of the taxable year, or at the beginning of the month, in which the obligations being tested are acquired. Such determinations must be made by use of the same method with respect to any taxable year, but the use of one method for a taxable year does not preclude the use of the other method, at the option of the DISC, for any other taxable year.

(4) *Treatment of obligations exceeding limitations.* if a DISC holds obligations which could otherwise be treated as Export-Import Bank obligations or financing obligations but for the limitation of subparagraph (2) of this paragraph, the DISC shall identify on its books and records which obligations are within such limitations. An obligation which fails by reason of such limitation to be an Export-Import Bank obligation or a financing obligation for the taxable year of a DISC (or month) in which it ias acquired shall not be treated as an Export-Import Bank obligation or financing obligation for any subsequent taxable year of the DISC (or month), but, nevertheless, shall be taken into account for purposes of subparagraph (2)(ii) of this paragraph.

(i) *Financing obligations*—(1) *In general.* For purposes of this section, subject to the limitation described in paragraph (h) (2), (3), and (4) of this section financing obligations are obligations (held by a DISC) of a domestic corporation organized solely for the purpose of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such Bank.

(2) *Limitation.* Obligations described in subparagraph (1) of this paragraph which are acquired after November 3, 1972, are financing obligations only to the extent that under the principles of paragraph (h) of this section, the sum of the adjusted bases of such obligations (as determined under section 1011) does not exceed the amount of the accumulated DISC income of the DISC (as reduced by the outstanding amount of producer's loans of the DISC).

(j) *Funds awaiting investment*—(1) *In general.* For purposes of this section, subject to the limitation descibed in subparagraph (2) of this paragraph, if, at the close of a DISC's taxable year, the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits in the United States to the extent of the amount of this excess are funds awaiting investment at the close of such taxable year.

(2) *Limitation.* Bank deposits described in subparagraph (1) of this paragraph are funds awaiting investment only if, by the last day of each of the sixth, seventh, and eighth months after the close of such taxable year, the sum of the adjusted bases of the qualified export assets of the DISC (other than such bank deposits) equals or exceeds 95 percent of the sum of the adjusted bases of all assets of the DISC (including such bank deposits) it held on the last day of such taxable year. For purposes of this subparagraph, the adjusted bases of assets of a DISC are determined as of the end of each of the months referred to in this subparagraph. Funds awaiting investment as described in this paragraph need not be traceable to any of the qualified export assets held by the DISC at the end of any of the months referred to in this subparagraph.

(3) *Coordination with certain deficiency distribution provisions.* Under section 992(c)(3) and § 1.992-3(d) a deficiency distribution made on or before the 15th day of the ninth month after the end of a corporation's taxable year is deemed to be for reasonable cause if certain requirements are met, including the requirement (described in section 992(c)(3)(B) and § 1.992-3(d)(2)) that the sum of the adjusted bases of the qualified export assets held by the corporation on the last day of each month of such year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such last day. If, on any such last day, the sum or a DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits to the extent of the amount of this excess are funds awaiting investment on such last day, if either—

(i) The requirements of subparagraph (2) of this paragraph are satisfied with respect to the taxable year of the DISC which includes such month or

(ii) At the close of such taxable year the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section not to exceed an amount reasonably necessary to meet the DISC's requirements for working capital.

[T.D. 7514, 42 FR 55459, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977]

§ 1.993-3 Definition of export property.

(a) *General rule.* Under section 993 (c), except as otherwise provided with respect to excluded property in paragraph (f) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a DISC)—

(1) Manufactured, produced, grown, or extracted in the United States by any person or persons other than a DISC (see paragraph (c) of this section),

(2) Held primarily for sale or lease in the ordinary course of a trade or business to any person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section),

(4) Which is not sold or leased by a DISC, or with a DISC as commission agent, to another DISC which is a member of the same controlled group (as defined in § 1.993-1(k) as the DISC, and

(5) Which is not sold or leased by any person to a Western Hemisphere trade corporation (as defined in section 921) which is a related person (as defined in § 1.993-1(a)(6)) with respect to the seller, lessor, or commission agent (if any) for any purpose, other than such Western Hemisphere trade corporation's sole use or consumption; any property not sold or leased by such corporation to another person within 3 years from the date of the sale or beginning of the term of the lease to such corporation shall be treated as if it were purchased or leased for the corporation's sole use or consumption.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property*—(1) *By a person other than a DISC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that such person does not qualify (and is not treated) as a DISC. Property held by a DISC which was manufactured, produced, grown, or extracted by it at a time when it did not qualify (and was not treated) as a DISC is not export property of the DISC. Property which sustains further manufacture or production outside the United States prior to sale or lease by a person but after manufacture or production in the United States will not be considered as manufactured, produced, grown, or extracted in the United States by such person.

(2) *Manufactured or produced*—(i) *In general.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured or produced by such person if such property is manufactured or produced (within the meaning of either subdivision (ii), (iii), or (iv) of this subparagraph) by such person or by another person pursuant to a contract with such person. Except as provided in subdivision (iv) of this subparagraph, manufacture or production of property does not include assembly or packaging operations with respect to property.

(ii) *Substantial transformation.* Property is manufactured or produced by a person if such property is substantially transformed by such person. Examples of substantial transformation of property would include the conversion of woodpulp to paper, steel rods to screws and bolts, and the canning of fish.

(iii) *Operations generally considered to constitute manufacturing.* Property is manufactured or produced by a person if the operations performed by such person in connection with such property are substantial in nature and are generally considered to constitute the manfacture or production of property.

(iv) *Value added to property.* Property is manufactured or produced by a person if with respect to such property conversion costs (direct labor and factory burden including packaging or assembly) of such person account for 20 percent of more of—

(*a*) The cost of goods sold or inventory amount of such person for such property is such property is sold or held for sale, or

(*b*) The adjusted basis of such person for such property, as determined in accordance, with the provisions of section 1011, if such property is held for lease or leased.

The value of parts provided pursuant to a services contract, as described in § 1.993-1 (d) (4) (v), is not taken into account in applying this subdivision.

(d) *Primary purpose of which property is held*—(1) *In general*—(i) *General rule.* Under paragraph (a) (2) of this section, export property (*a*) must be held primarily for the purpose of sale or lease in the ordinary course of trade or business to a DISC, or to any other person, and (*b*) such sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if such sale or lease satisfies the destination test described in subparagraph (2) of this paragraph, the proof of compliance requirements described in subparagraph (3) of this paragraph, and the use outside the United States test described in subparagraph (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a DISC is sold or leased for direct use consumption, or disposition outside the United States, the fact that the acquiring DISC holds the property in inventory or for lease prior to the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Export property need not be physically segregated from other property

(2) *Destination test.* (i) For purposes of subparagraph (1) of this paragraph the destination test in this subparagraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by such seller or lessor (or an agent of such seller or lessor) regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor—

(*a*) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee)

(*b*) Within the United States to a purchaser or lessee, if such property is ultimately delivered, directly used, or directly consumed outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after such sale or lease,

(*c*) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a DISC and is not a member of the same controlled group (as defined in § 1.993-1(k)) as the seller or lessor.

(*d*) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of a ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor.

(*e*) Outside the United States to a purchaser or lessee from a warehouse, a storage facility, or assembly site located outside the United States, if such property was previously shipped by such seller or lessor from the United States, or

(*f*) Outside the United States to a purchaser or lessee if such property was previously shipped by such seller or lessor from the United States and if such property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (*1*) such prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (*2*) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (*3*) the lessee under the subsequent lease is not a related person (as defined in § 1.993-1(a)(6)) with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this subparagraph (other than (*c*) and (*f*) (*3*) of subdivision (i) thereof), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this subparagraph satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this subparagraph.

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of subparagraph (2) of this paragraph (other than subdivision (i)(*c*) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(*a*) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(*b*) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(*c*) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered.

(*d*) If such country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(*e*) A facsimile or carbon copy of the shipper's export declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property,

(*f*) Any other proof (including evidence as to the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i) (*a*), (*b*), (*c*), or (*e*) of this subparagraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in such subdivision (*e*) or a document such as an export bill of lading such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that such document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of subparagraph (2)(i) of this paragraph (other than subdivision (*c*) thereof), that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) *Sale or lease to an unrelated DISC.* For purposes of subparagraph (2)(i)(*c*) of this paragraph, a purchaser or lessee of property is deemed to qualify as a DISC for its taxable year if the seller or lessor obtains from such purchaser or lessee a copy of such purchaser's or lessee's election to be treated as a DISC as described in § 1.992-2(a) together with such purchaser's or lessee's sworn statement that such election has been filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of such purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a DISC with respect to a sale or lease during a taxable year for which such purchaser or lessee does not qualify as a DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time such sale or lease is made that the purchaser or lessee will qualify as a DISC for such taxable year.

(v) *Failure of proof.* If a seller or lessor fails to provide proof of compliance with the destination test as required by this subparagraph, the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the use test in this subparagraph is satisfied with respect to property which—

(*a*) Under subdivisions (ii) through (iv) of this subparagraph is not sold for ultimate use in the United States or

(*b*) Under subdivision (v) of this subparagraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (i) of this subparagraph, a purchaser of property (including components, as defined in subdivision (vii) of this subparagraph) is deemed to use such property ultimately in the United States if any of the following conditions exists:

(*a*) Such purchaser is a related person (as defined in § 1.993-1(a)(6)) with respect to the seller and such purchaser ultimately uses such property, or a second product into which such property is incorporated as a component, in the United States.

(*b*) At the time of the sale, there is an agreement or understanding that such property, or a second product into which such property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(*c*) At the time of the sale, a reasonable person would have believed that such property or such second product would be ultimately used by such purchaser in the United States unless, in the case of a sale of components, the fair market value of such components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which such components are incorporated (determined at the time of completion of the production, manufacture or assembly of such second product).

For purposes of (b) of this subdivision, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (ii) of this subparagraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by such purchaser if, at any time within 3 years after the purchase of such property or components, either such property or components (or the second product into which such components are incorporated) is resold by such purchaser for use by a subsequent purchaser within the United States or such purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use such property or second product predominantly outside the United States as defined in subdivision (vi) of this subparagraph).

(iv) *Sales to retailers.* For purposes of subdivision (ii)(c) of this subparagraph property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets ouside the United States will be considered as property for ultimate use outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (i) of this subparagraph a lessee of property is deemed to use such property ultimately outside the United States during a taxable year of the lessor if such property is used predominantly outside the United States (as defined in subdivision (vi) of this subparagraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this subparagraph, property is used predominantly outside the United States for any period if, during such period, such property is located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes in deemed to be used predominantly outside the United States for any period if, during such period, either such property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of such property are traversed in outside the United States. However, any such property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where such transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations thereunder (relating to tax on air transportation of persons). For purposes of applying section 4262(c)(3) to this subdivision, the term "United States" has the same meaning as in § 1.993-7.

(vii) *Component.* For purposes of this subparagraph, a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

(e) *Foreign content of property*—(1) *The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph, articles imported into the United States are referred to as "foreign content". The fair market value of the foreign content of export property is computed in accordance with subparagraph (4) of this paragraph. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest finance or carrying charges, or similar charges)

(2) *Application of 50 percent test.* The 50 percent test described in subparagraph (1) of this paragraph is applied on an item-by-item basis If, however, a person sells or leases a substantial volume of substantially identical export property in a taxable year and if all of such property contains substantially identical foreigh content is substantially the same proportion, such person may determine the protion of foreign content contained in such property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in § 1.993-1(d)(4)(v)) and the price for the parts is not separately stated, the 50 percent test described in subparagraph (1) of this paragraph is applied on an aggregate basis to the property and parts. If the price for the parts is described in subparagraph (1) of this paragraph is applied separately to the property and to the parts.

(4) *Computation of foreign content*—(i) *Valuation.* For purposes of applying the 50 percent test described in subparagraph (1) of this paragraph, it is necessary to determine the fair market value of all articles which constitute foreign content of the property being tested to determine if it is export property. The fair market value of such imported articles is determined as of the time such articles are imported into the United States and is their appraised value, as determined under section 402 or 402a of the Tariff Act of 1930 (19 U.S.C. 1401a or 1402) in connection with their importation. The appraised value of such articles is the full dutiable value of such articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value. Thus, an article which is imported into the United States is treated as entirely imported even if all or a portion of such article was originally manufactured, produced, grown, or extracted in the United States.

(ii) *Evidence of fair market value.* For purposes of subdivision (i) of this subparagraph, the fair market value of imported articles constituting foreign content may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of such articles is not the importer (or a related person with respect to the importer), the fair market value of such articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to the holder by the person from whom such articles (or property incorporating such articles) were purchased. If a customs invoice or certificate described in the preceding sentence is not available to a person purchasing property, such person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(iii) *Interchangeable component articles.* (*a*) Where identical or similar component articles can be incorporated interchangeably into property and a person acquires some such component articles that are imported into the United States and other such component articles that are not imported into the United States, the determination whether imported component articles were incorporated in such property as is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(*b*) The provisions of (*a*) of this subdivision may be illustrated by the following example:

Example. Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a DISC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the DISC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the DISC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the DISC, those devices are not export property. The remaining 8,000 devices purchased and exported by the DISC are treated as containing tubes produced in United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property--

(i) Property described in subparagraph (2) of this paragraph (relating to property leased to a member of a controlled group),

(ii) Property described in subparagraph (3) of this paragraph (relating to certain types of intangible property),

(iii) Products described in paragraph (g) of this section (relating to depletable products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group.* (i) *In general.* Property leased to a person (whether or not a DISC) which is a member of the same controlled group (as defined in § 1.993-1(k)) as the lessor constitutes export property for any period of time only if during the period—

(*a*) Such property is held for sublease, or is subleased, by such person to a third person for the ultimate use of such third person;

(*b*) such third person is not a member of the same controlled group; and

(*c*) Such property is used predominantly outside the United States by such third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (i)(*c*) of this subparagraph whether such property is used predominently outside the United States by such third person.

(iii) *Leasing rule.* For purposes of this subparagraph, leased property is deemed to be ultimately used by a member of the same controlled group as the lessor if such property is leased to a person which is not a member of such controlled group but which subleases such property to a person which is a member of such controlled group. Thus, for example, if X, a DISC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of such group for showing to the general public, the film is not export property. On the other hand, if X, a DISC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified under this subparagraph from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subparagraph (3) of this paragraph from being export property, the ultimate use of such property is the sale or exhibition of such property to the general public. Thus, if a DISC for the taxable year leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this subparagraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (i.e., property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property.

(g) *Depletable products*—(1) *In general.* Under section 993(c)(2)(C), a product or commodity which is a depletable product (as defined in subparagraph (2) of this paragraph) or contains a depletable product is not export property if—

(i) It is a primary product from oil, gas, coal, or uranium (as described in subparagraph (3) of this paragraph), or

(ii) It does not qualify as a 50-percent manufactured or processed product (as described in subparagraph (4) of this paragraph).

(2) *Definition of "depletable product".* For purposes of this paragraph, the term "depletable product" means any product or commodity of a character with respect to which a deduction for depletion is allowable under section 613 or 613A. Thus, the term depletable product includes any mineral extracted from a mine, an oil or gas well, or any other natural deposit, whether or not the DISC or related supplier is allowed a deduction, or is eligible to take a deduction, for depletion with respect to the mineral in computing its taxable income. Thus, for example, iron ore purchased by a DISC from a broker is a depletable product in the hands of the DISC for purposes of this paragraph even though the DISC is not eligible to take a deduction for depletion under section 613 or 613A.

(3) *Primary product from oil, gas, coal, or uranium.* A primary product from oil, gas, coal, or uranium is not export property. For purposes of this paragraph—

(i) *Primary product from oil.* The term "primary product from oil" means crude oil and all products derived from the destructive distillation of crude oil, including—

(*a*) Volatile products,

(*b*) Light oils such as motor fuel and kerosene,

(*c*) Distillates such as naphtha,

(*d*) Lubricating oils,

(*e*) Greases and waxes, and

(*f*) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term "primary product from gas" means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

(*a*) Natural gas,

(*b*) Condensates,

(*c*) Liquefied petroleum gases such as ethane, propane, and butane, and

(*d*) Liquid products such as natural gasoline.

(iii) *Primary product from coal.* The term "primary product from coal" means coal and all products recovered from the carbonization of coal including—

(*a*) Coke,

(*b*) Coke-oven gas,

(*c*) Gas liquor,

(*d*) Crude light oil, and

(*e*) Coal tar.

(iv) *Primary product from uranium.* The term "primary product from uranium" means uranium ore and uranium concentrates (known in the industry as "yellow cake"), and nuclear fuel materials derived from the refining of uranium ore and uranium concentrates, or produced in a nuclear reaction, including—

(*a*) Uranium hexafluoride,

(*b*) Enriched uranium hexafluoride,

(*c*) Uranium metal,

(*d*) Uranium compounds, such as uranium carbide,

(*e*) Uranium dioxide, and

(*f*) Plutonium fuels.

(v) *Primary products and changing technology.* The primary products from oil, gas, coal, or uranium described in subdivisions (i) through (iv) of this subparagraph and the processes described in those subdivisions are not intended to represent either the only primary products from oil, gas, coal, or uranium, or the only processes from which primary products may be derived under existing and future technologies, such as the gasification and liquefaction of coal.

(vi) *Petrochemicals.* For purposes of this paragraph, petrochemicals are not considered primary products from oil, gas, or coal.

(4) *50-percent manufactured or processed product*—(i) *In general.* A product or commodity (other than a primary product from oil, gas, coal, or uranium) which is or contains a depletable product is not excluded from the term "export property" by reason of section 993(c)(2)(C) if it is a 50-percent manufactured or processed product. Such a product or commodity is a "50-percent manufactured or processed product" if, after the cutoff point of the depletable product, it is manufactured or processed (as defined in subdivision (ii) of this subparagraph) and either the cost test described in subdivision (iv) of this subparagraph or the fair market value test described in subdivision (v) of this subparagraph is satisfied. To determine cutoff point, see subdivisions (vi) and (vii) of this subparagraph.

(ii) *Manufactured or processed.* A product is manufactured or processed if it is manufactured or produced within the meaning of paragraph (c)(2) of this section, except that for purposes of this subdivision the term manufacturing or processing does not include any excluded process (as defined in subdivision (iii) of this subparagraph) and the term conversion costs (as used in subdivision (iv) of such paragraph (c)(2)) does not include any costs attributable to any excluded process.

(iii) *Excluded processes.* For purposes of this paragraph, excluded processes are extracting (*i.e.*, all processes which are applied before the cutoff point of the mineral to which such processes are applied), and handling, packing, packaging, grading, storing, and transporting.

(iv) *Cost test.* A product or commodity will qualify as a 50-percent manufactured or processed product if—

(*a*) Its manufacturing and processing costs (that is, the portion of the cost of goods sold or inventory amount of the product or commodity attributable to the aggregate cost of manufacturing or processing each mineral contained therein) equal or exceed—

(*b*) An amount equal to either of the following:

(*1*) 50 percent of its cost of goods sold or inventory amount (decreased, at the DISC's option, by the portion of such cost or amount the DISC establishes is allocable to the difference between each prior owner's selling price for each depletable product contained in such product or commodity and such prior owner's cost of goods sold with respect thereto).

(*2*) The aggregate of the cost at the cutoff point (see subdivisions (vi) and (vii) of this subparagraph) properly attributable to each mineral contained in such product or commodity. However, if this subdivision (*2*) is applied, then the amount in (*a*) of this subparagraph (iv) shall be decreased and the amount in this subdivision (*2*) shall be increased, by so much of the cost of goods sold or inventory amount of the product or commodity as is properly allocable to any process other than transportation applied after the cutoff point of such mineral which would be a mining process (within the meaning of § 1.613-4) were it applied before such point.

(v) *Fair market value test.* A product or commodity will qualify as a 50-percent manufactured or processed product if—

(*a*) The excess of its fair market value on the date it is sold, exchanged, or otherwise disposed of (or, if not sold, exchanged, or otherwise disposed of, the last day of the DISC's taxable year) over the portion thereof properly allocable to excluded processes other than extracting is equal to or greater than

(*b*) Twice the aggregate of the fair market value at the cutoff point for each mineral contained in such product or commodity.

For purposes of this subdivision (v), the fair market value of a product or commodity on the date it is sold, exchanged, or otherwise disposed of is the price at which it is disposed of, subject to any adjustment that may be required under the arm's length standard of section 482 and the regulations thereunder. If such product or commodity is not sold, exchanged, or otherwise disposed of, then, for purposes of section 992(a)(1)(B) (relating to the 95-percent test with respect to qualified export assets), the fair market value of a product or commodity on the last day of the DISC's taxable year is the arm's length price at which such product or commodity would have been sold on such date, determined by applying the principles of section 482 and the regulations thereunder.

(vi) *Cutoff point of a mineral.* For purposes of this subparagraph:

(*a*) The cutoff point is the point at which gross income from the property (within the meaning of section 613(a)) was in fact determined.

(*b*) The cost at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral.

(*c*) The fair market value at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral, except that, if (*1*) the fair market value of a product or commodity on the date specified in subdivision (v)(*a*) of this subparagraph exceeds the aggregate of the fair market value at the cutoff point for each mineral contained therein and (*2*) 10 percent or more of such excess is attributable to a net increase in the fair market values of such minerals by reason of factors other than manufacturing or processing or the application of excluded processes (such as, for example, increases in the fair market values of some minerals by reason of inflation or speculation exceed decreases in such values of other minerals by reason of deflation or speculation), then the aggregate of the fair market value at the cutoff point for each such mineral shall be increased to reflect the net excess so attributable.

(*d*) The provisions of this subdivision (vi) are illustrated by the following example.

Example. An integrated manufacturer, X, on February 1, 1976, had gross income from the property (within the meaning of section 613(a)) of $50 with respect to a specified volume of a mineral. Thus, the cost at the cutoff point of the mineral was $50. X converted the mineral into a product which it sold on July 15, 1976, for $75. Of the $25 excess of the selling price over the gross income from the property, $23 was attributable to manufacturing, processing, and the application or excluded processes, and $2 was attributable to an increase in the fair market value of the mineral due to inflation between February 1 and July 15, 1976. Since only 8 percent of such excess ($2/$25) was attributable to factors other than manufacturing, processing, and the application of excluded processes, the fair market value at the cutoff point of the mineral is $50. However, had $3 of the $25 excess, or 12 percent, been attributable to an incease in the fair market value of the mineral due to inflation, then the fair market value at the cutoff point of the mineral would be $53.

(vii) [Reserved]

(viii) *Special rule for certain used products and scrap products.* If a product or commodity is a used 50-percent manufactured or processed product, or is recovered as scrap from a 50-percent manufactured or processed product, such product or commodity will be treated as a 50-percent manufactured or processed product.

(ix) *Special rule for byproducts and waste products.* For purposes of applying the cost test or fair market value test of subdivision (iv) or (v) of this subparagraph if a depletable product is recovered from a manufacturing process as a byproduct or waste product, then the cost and fair market value at the cutoff point are each deemed to be the lesser of—

(*a*) The fair market value of the waste product or byproduct containing the depletable product, determined as of the date the byproduct or waste product is recovered, or

(*b*) The amount the cost at the cutoff point would be for a depletable product of like kind and grade which is extracted, determined as of the date the byproduct or waste product is recovered.

For purposes of (*b*) of this subdivision the cutoff point for the depletable product of like kind and grade is deemed to be the point at which gross income from the property would be determined if such depletable product were sold by the taxpayer eligible to take a deduction for depletion after the completion of all mining processes applied to the depletable product and before the application of any nonmining process.

(x) *Proof of satisfaction of 50-percent manufactured or processed test.* (*a*) No substantiation is required to establish that either the cost test or the fair market value test of subdivisions (iv) or (v) of this subparagraph is satisfied or that a product or commodity qualifies under (viii) of this subdivision as either a used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product as long as it is reasonably obvious, on the basis of all relevant facts and circumstances, that either the cost test or fair market value test is satisfied, or that the product or commodity qualifies as either as used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product. Thus, for example, in the case of a DISC exporting a high precision lens at least 50 percent of the fair market value of which is obviously attributable to grinding, no substantiation of gross income from the property properly allocable to the depletable products contained in the lens, cost, or fair market values will be required.

(*b*) In cases in which satisfaction of either the cost test or the fairmarket value test is not reasonably obvious, a DISC will be required to substantiate the gross income from the property properly allocable to each depletable product in a product or commodity and either all costs or fair market values relied upon the DISC.

(*c*) For purposes of substantiating (*1*) gross income from the property properly allocable to a depletable product, (*2*) costs, and (*3*) fair market values, the DISC and related supplier shall each identify items in (or that were in) inventory in the same manner each used to identify items in inventory for purposes of computing Federal income tax.

(xi) *Application of 50-percent test.* The 50-percent test described in this subparagraph is applied on an item-by-item basis. If, however, a DISC sells a substantial volume of substantially identical products or commodities and if all or a group of such products or commodities contain substantially identical depletable products in substantially the same proportions and have cost or fair market value relationships (as the case may be) that are in substantially the same proportions, such DISC may apply the 50-percent test on an aggregate basis with respect to all such products or commodities, or group, as the case may be.

(5) *Effective dates.* Except as provided in subparagraph (6) of this paragraph, section 993(c)(2)(C) applies—

(i) With respect to any product or commodity not owned by a DISC, to sales, exchanges, or other dispositions made after March 18, 1975, with respect to which the DISC derives gross receipts.

(ii) With respect to any product or commodity acquired by a DISC after March 18, 1975.

(iii) With respect to any product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, or other dispositions made after March 18, 1976, and to owning such product or commodity after such date.

For purposes of this paragraph and subparagraph (6) of this paragraph, the date of a sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The accounting method of a person is not determinative of the date of a sale, exchange, or other disposition.

(6) *Fixed contracts.* Section 1101(f) of the Tax Reform Act of 1976 provides an exception to the effective date rules in this paragraph and in paragraph (h) of this section. Section 1101(f)(2) of the Act provides that section 993)c)(2) (C) and (D) shall not apply to sales, exchanges, and other dispositions made after March 18, 1975, but before March 19, 1980, if they are made pursuant to a fixed contract. Section 1101(f)(2) also defines fixed contract. Under that definition, if the seller can vary the price of the product for unspecified cost increases (which could include tax cost increases), or if the quantity of products or commodities to be sold can be increased or decreased under the contract by the seller without penalty, the contract is not to be considered a fixed contract with respect to the amount over which the seller has discretion. For example, if a contract calls for a minimum delivery of *x* amount of a product but allows the seller to refuse to deliver goods beyond that minimum amount (or allows a renegotiation of the sales price of goods beyond that amount), then with respect to the amount above the minimum the contract is not a fixed quantity contract.

(h) *Export controlled products*—(1) *In general.* Under section 993(c)(2)(D), an export controlled product is not export property. For purposes of this paragraph, the term "export controlled product" means any product or commodity the export of which is prohibited or curtailed under section 4(b) of the Export Administration Act of 1969 (50 U.S.C. App. 2403(b)) to effectuate the policy set forth in paragraph (2)(A) of section 3 of such Act. The policy set forth in paragraph (2)(A) of section 3 of the Export Administration Act of 1969 is "to use export controls to the extent necessary to protect the domestic economy from the excessive drain of scarce materials and to reduce the serious inflationary impact of foreign demand."

(2) *Products considered export controlled products*—(i) *In general.* For purposes of this paragraph, an export controlled product is a product or commodity which is subject to short supply export controls under 15 CFR Part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (ii) of this subparagraph) and ends on and includes the final control date (as defined in subdivision (iii) of this subparagraph).

(ii) *Initial control date.* The initial control date of a product or commodity which was subject to short supply export controls on March 19, 1975, is March 19, 1975. The initial control date of a product or commodity which is subject to short supply export controls after March 19, 1975, is the effective date stated in the regulations to 15 CFR Part 377 which subjects such product or commodity to short supply export controls. If there is no effective date stated in such regulations, the initial control date of such product or commodity is the date on which such regulations are filed for publications in the FEDERAL REGISTER.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR Part 377 which removes such product or commodity from short supply export controls. If there is no effective date stated in such regulations, the final control date of such product or commodity is the date on which such regulations are filed for publication in the FEDERAL REGISTER.

(iv) *Expiration of Export Administration Act of 1969.* An initial control date and a final control date cannot occur after the date on which the Export Administration Act of 1969 expires.

(3) *Effective dates*—(i) *Products controlled on March 19, 1975.* Except as provided in paragraph (g)(6) of this section, if a product or commodity was subject to short supply export controls on March 19, 1975, section 993(c)(2)(D) applies—

(*a*) With respect to any such product or commodity not owned by a DISC, to sales, exchanges, other dispositions, or leases made after March 18, 1975, with respect to which the DISC derives gross receipts.

(*b*) With respect to any such product or commodity acquired by a DISC after March 18, 1975, and

(*c*) With respect to any such product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, other dispositions, and leases made after March 18, 1976, and to owning such product or commodity after such date.

(ii) *Products first controlled after March 19, 1975.* If a product or commodity becomes subject to short supply export controls after March 19, 1975, section 993(c)(2)(D) applies to sales, exchanges, other dispositions, and leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sale, exchange, lease, or other disposition.* For purposes of this subparagraph, the date of sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(iv) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive order designate such property as in short supply. Any property so designated will be treated as property which is not export property during the period beginning with the date specified in such Executive order and ending with the date specified in an Executive order setting forth the President's determination that such property is no longer in short supply.

[T.D. 7514, 42 FR 55461, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57309, Nov. 2, 1977; T.D. 7514, 42 FR 60910, Nov. 30, 1977]

§ 1.993-4 Definition of producer's loans.

(a) *General rule*—(1) *Definition.* Under section 993(d), a loan made by a DISC to a person, referred to in this section as the "borrower," is a producer's loan if—

(i) The loan is made out of accumulated DISC income within the meaning of subparagraph (3) of this paragraph.

(ii) The loan is evidenced by an obligation described in subparagraph (4) of this paragraph.

(iii) The requirement as to the trade or business of the borrower described in subparagraph (5) of this paragraph is satisfied.

(iv) At the time the loan is made, the obligation referred to in subdivision (ii) of this subparagraph bears a legend stating "This Obligation Is Designated A Producer's Loan Within The Meaning of Section 993(d) of the Internal Revenue Code" or words of substantially the same meaning.

(v) The limitation as to the export-related assets of the borrower described in paragraph (b) of this section is satisfied.

(vi) The requirement as to the increased investment of the borrower in export-related assets described in paragraph (c) of this section is satisfied, and

(vii) The requirement of paragraph (d) of this section as to proof of complance with paragraphs (b) and (c) of this section is satisfied.

(2) *Application of this section*—(i) *In general.* A loan which is a producer's loan is a qualified export asset of the DISC (see § 1.993-2(a)(5) and (F)). The interest on a producer's loan is a qualified export receipt of the DISC (see § 1.993-1(g)). A producer's loan is not a dividend to a borrower which is also a shareholder of the DISC making the loan. For rules with respect to deemed distributions by reason of the amount of foreign investment attributable to producer's loans, see section 995(b)(1)(G) and (d) and the regulations thereunder.

(ii) *No tracing of loan proceeds.* For purposes of applying this section, in order to qualify as a producer's loan, the proceeds of the loan need not be traced to an investment in any specific asset.

(iii) *Unrelated borrower.* For purposes of applying this section, it is not necessary for a borrower to be a related person with respect to the DISC from which it receives a producer's loan, or a member of the same controlled group as the DISC.

(iv) *Unpaid balance of producer's loans.* For purposes of applying this section, the unpaid balance of producer's loans does not include the unpaid balance of any producer's loan to the extent the loan has been deducted or charged off by the DISC as totally or partially worthless under section 165 or 166.

(v) *Refinancing, renewal, and extension.* For purposes of applying this section, the refinancing, renewal, or extension of a producer's loan shall be treated as the making of a new loan which may qualify as a producer's loan only if the requirements of subparagraph (1) of this paragraph are met.

(vi) *Events subsequent to time loan is made.* The determination as to whether a loan qualifies as a producer's loan is made on the basis of the relevant facts taken into account for purposes of determining whether the loan was a producer's loan when made. Thus, for example, if the accumulated DISC income of the lender is later reduced below the unpaid balance of all producer's loans previously made by the DISC, such subsequent decrease in the amount of accumulated DISC income will not result in later disqualification of such loan (or part thereof) as a producer's loan. Similarly, if a loan (or part of a loan) does not qualify as a producer's loan because of an insufficient amount of accumulated DISC income at the time the loan is made, a subsequent increase in the amount of accumulated DISC income will not result in later qualification of such loan (or part thereof) as a producer's loan. For a further example, if a loan qualifies as a producer's loan when made but if made in a subsequent taxable year it would not have so qualified because the property manufactured, produced, grown, or extracted in the United States by the borrower is excluded property under section 993(c)(2) (C) or (D), the application of the excluded property rule will not result in later disqualification of such loan (or part thereof) as a producer's loan. As a further example, for purposes of applying the borrower's export related assets limitation described in paragraph (b) of this section, a loan which qualifies as a producer's loan when made will not later be disqualified if property, the gross receipts from the sale or lease of which were includible in numerator of the fraction described in paragraph (b)3)(i) of this section at the time of sale or lease by the borrower, is later characterized as excluded property (as defined in § 1.993-3(f)).

(vii) *Application of tests under paragraphs (b) and (c) on controlled group bases.* If the borrower is a member of a controlled group (as defined in § 1.993-1(k)) at the time a loan is made, all amounts that must be determined for purposes of applying the limitation and increased investment requirement with respect to the export-related assets of the borrower (described in paragraphs (b) and (c), respectively, of this section) may be determined at the election of the borrower by aggregating such amounts for all members of the controlled group, determined for the taxable year of each member of the controlled group during which the loan is made, excluding only such members of the group as are DISC's or foreign corporations for such year. However, such amounts may be included only to the extent that such amounts have not already been taken into account in applying the limitation and increased investment requirement with respect to any other borrower. Amounts to be aggregated for all such members if such election is made include, for example, gross receipts (described in paragraph (b)(3) (i) and (ii) of this section) and export-related assets (described in paragraph (b)(2) of this section). The borrower may make such election by causing its written statement of election to be attached to the lending DISC's return under section 6011(e)(2) for the first taxable year of the lending DISC within which or with which the borrower's taxable year for which the election is to apply ends. An election once made is binding on all members of the controlled group which includes the borrower with respect to all taxable years of the borrower beginning with its first taxable year for which the election is made. A borrower who makes such election may revoke it only if it secures the consent of the Commissioner to such revocation upon application made through the lending DISC.

(3) *Loan out of accumulated DISC income*—(i) *In general.* A loan is a producer's loan only to the extent that it is made out of accumulated DISC income. A loan is made out of accumulated DISC income only if the amount of the loan, when added to the unpaid balance at the time such loan is made of all other producer's loans made by a DISC, does not exceed the amount of accumulated DISC income of the DISC at the beginning of the month in which the loan is made. The amount of accumulated DISC income at the beginning of any month is determined as if the DISC's taxable year closed at the end of the immediately preceding month.

(ii) *Presumption.* A loan made during a taxable year shall be deemed under subdivision (i) of this subparagraph to have been made out of accumulated DISC income if the balance of producer's loans at the beginning of the year and those made during the year do not exceed accumulated DISC income at the end of the year.

(iii) *Deemed distributions.* For purposes of this subparagraph, accumulated DISC income as of the end of any taxable year (or month) shall be determined without regard to deemed distributions under section 995(b)(1)(G) for the amount of foreign investment attributable to producer's loans for such year (or for the taxable year for which such month is a part) but actual distributions shall be taken into account.

(4) *Evidence and terms of obligation.* A loan is a producer's loan only if the loan is evidenced by a note or other evidence of indebtedness which is made by the borrower and which has a stated maturity date not more than 5 years from the date the loan is made. Accordingly, a loan which does not have a stated maturity date or which has a stated maturity date more than 5 years from the date such loan is made can never meet the 5-year requirement of this subparagraph. Thus, for example, even if there is a period of less than 5 years remaining to the stated maturity date of a loan, the loan can never be a producer's loan if it had a stated maturity date more than 5 years from the date it was made. For a further example, if a loan having a period remaining to maturity of 2 years is extended for a further period of 3 years (making a total of 5 years to maturity from the date of the extension), the extension of the loan would under subparagraph (2)(v) of this paragraph constitute the making of a new producer's loan and the original producer's loan would terminate. If, however, a loan having a period remaining to maturity of 2 years is extended for a further period of 4 years (making a total of 6 years to maturity from the date of the extension), the original producer's loan will terminate and the new loan will not be a producer's loan. If a producer's loan is not paid in full at its maturity date and is not formally refinanced, renewed, or extended, such loan shall be deemed to be a new loan which does not have a stated maturity date and, thus, will not be a producer's loan. For purposes of this subparagraph, an evidence of indebtedness is a written instrument of indebtedness. Section 482 and the regulations thereunder are applicable to determine, in the case of a loan by the DISC to a borrower which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482, whether the interest charged on such loan is at an arm's length rate.

(5) *Borrower's trade or business.* A loan is a producer's loan only if the loan is made to a person engaged in the activity of manufacture, production, growth, or extraction of export property (within the meaning of § 1.993-3(c)) in the United States by such person. The borrower may also be engaged in other trades or businesses, and the loan need not be traceable to specific investments in export property.

(b) *Borrower's export related assets limitation*—(1) *General rule.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount equal to the amount of the borrower's export-related assets (determined under subparagraph (2) of this paragraph) multiplied by the fraction set forth in subparagraph (3) of this paragraph.

(2) *Amount of export-related assets*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the amount of the borrower's export-related assets is the sum of the amounts described in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) *Borrower's plant and equipment.* The amount described in this subdivision is the sum of the borrower's adjusted bases (determined as of the beginning of the borrower's taxable year in which a loan is made to it) for plant, machinery, equipment, and supporting production facilities, which are located in the United States. Supporting production facilities are all property used primarily in connection with the manufacture, production, growth, or extraction (within the meaning of § 1.993-3(c)) or storage, handling, transportation, or assembly of property by the borrower.

(iii) *Borrower's property held primarily for sale or lease.* The amount described in this subdivision is the amount of the borrower's property (at the beginning of the taxable year of the borrower in which a loan is made to it) held primarily for sale or lease to customers in the ordinary course of its trade or business. The amount of such property held for sale is determined under the methods of identifying and valuing inventory normally used by the borrower. The amount of such property held for lease or leased is the borrower's adjusted bases, determined under section 1011, for such property.

(iv) *Borrower's research and experimental expenditures.* The amount described in this subdivision is the aggregate amount, whether or not charged to capital account, of research and experimental expenditures (within the meaning of section 174) incurred in the United States by the borrower during each of its taxable years which begin after December 31, 1971, and precede the taxable year in which the loan is made to the borrower. Such research and experimental expenditures need bear no relationship to export property (as defined in § 1.993-3) of the borrower. The aggregate amount of all such expenditures for each of such preceding taxable years is taken into account for purposes of this subparagraph, regardless of whether all or any portion of the aggregate amount has been taken into account with respect to producer's loans made to the borrower by any DISC in preceding taxable years. The aggregate amount of all such expenditures shall include such expenditures of a corporation, the assets of which were acquired by the borrower in a distribution or a transfer described in section 381(a) (1) or (2) (relating to carryovers in certain corporate acquisitions).

(3) *Fraction referred to in subparagraph (1) of this paragraph*—(i) *Numerator of fraction.* The numerator of the fraction set forth in this subparagraph is the sum of the borrower's gross receipts for each of its 3 taxable years immediately preceding the taxable year in which the loan is made (but not including any taxable year beginning before January 1, 1972) from the sale or lease of export property which is manufactured, produced, grown, or extracted (within the meaning of § 1.993-3(c)) by the borrower whether or not sold or leased directly or through a related Western Hemisphere trade corporation, or other domestic related person (notwithstanding § 1.993-3 (a) (4) and (5) and (f)(2). For purposes of the preceding sentence, with respect to a sale or lease to a related DISC in which the transfer price is determined under section 994(a) (1) or (2), the rules under § 1.994-1(c)(5) (relating to incomplete transactions) shall be applied, and with respect to all other sales and leases the rules under § 1.994-1(c)(5) other than subdivision (i)(d) therefore shall be applied.

(ii) *Denominator of fraction.* The denominator of the fraction set forth in this subparagraph is the sum of the amount included in the numerator and all other gross receipts of the borrower, for each of its taxable years for which gross receipts are included in the numerator of the fraction, from all sales or leases of all property held by the borrower primarily for sale or lease to customers in the ordinary course of its trade or business. For purposes of subdivision (i) of this subparagraph and this subdivision, if such property is sold or leased to a domestic related person which resells or subleases such property, the borrower's gross receipts shall be the gross receipts derived by the domestic related person from the resale or sublease of the export property.

(iii) *Taxable years.* If the borrower has not engaged in the sale or lease of property (as described in this subparagraph) for the 3 immediately preceding taxable years, or if 3 taxable years beginning after December 31, 1971, have not elapsed, the fraction will be computed on the basis of such gross receipts for its taxable years immediately preceding the loan and beginning after December 31, 1971, during which the borrower has so engaged. No producer's loans can be made to a borrower until after the end of the first taxable year of the borrower beginning after December 31, 1971.

(c) *Requirement for increased investment in export-related assets*—(1) *In general.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower during the borrower's taxable year during which such loan is made, does not exceed the amount of the borrower's increase for the year in investment in export-related assets. Such increase for any taxable year is the sum of—

(i) The increase (if any) in the borrowers adjusted basis of certain types of assets as determined under subparagraph (2) of this paragraph and

(ii) The amount (if any) during the year of its research and experimental expenditures as determined under paragraph (b)(2)(iv) of this section.

(2) *Increase in adjusted bases.* The amount under this subparagraph is the amount (not less than zero) by which—

(i) The borrower's adjusted basis (determined as of the end of its taxable year in which the producer's loan is made) in all of its property which is described in paragraph (b)(2)(ii) (plant and equipment), and (iii) (property held primarily for sale or lease) of this section, including any such property acquired by it during such taxable year, exceeds

(ii) Its adjusted bases in all such property (determined as of the beginning of such year).

(3) *Ordering rule.* If during the borrower's taxable year the amount of increase in investment in export-related assets determined under this subparagraph is exceeded by amounts loaned to the borrower during such year that would otherwise qualify as producer's loans, such loans shall be applied in the order made against the amount of such increase in order to determine which loans qualify as producer's loans.

(d) *Proof of borrower's compliance with paragraphs (b) and (c) of this section.* For purposes of paragraphs (b) and (c) of this section, a DISC shall be prepared to establish initially the compliance of the borrower with the requirements of such paragraphs by providing the written statement of the borrower, certified by a certified public accountant, stating that the borrower has complied with the limitation and increased investment requirement in section 993(d) (2) and (3) of the Internal Revenue Code of 1954. In lieu of certification by a certified public accountant, the DISC may attach to its return a statement signed by the borrower under penalties of perjury on a form provided by the Internal Revenue Service certifying that the borrower has complied with the limitation and increased investment requirement in section 993(d) (2) and (3) of the Internal Revenue Code of 1954. For taxable years ending after October 17, 1977, the DISC must attach either the certification by the certified public accountant or the certification by the borrower to its return. Additional full substantiation of the borrower's compliance with the requirements of such paragraphs may be required by the district director. If full substantiation of such compliance is not provided by the DISC (or the borrower) when required, the loan shall be deemed not to be a producer's loan.

(e) *Special limitation in the case of domestic film maker*—(1) *General rule.* The limitation of paragraph (b) of this section as to the export-related assets of the borrower will be considered satisfied if the DISC—

(i) Is engaged in the trade or business of selling or leasing films which are export property, or is acting as a commission agent for a person who is so engaged,

(ii) Makes a loan to a borrower which is a domestic film maker (as defined in subparagraph (5) of this paragraph) for the purpose of making a film, and

(iii) The amount of such loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount determined by multiplying—

(*a*) The sum of (*1*) the amount of the export-related assets of the borrower (determined under paragraph (b)(2)(i) of this section as of the beginning of the borrower's taxable year in which the loan is made), plus (*2*) the amount of a reasonable estimate of the amount of such export related assets obtained or to be obtained by the borrower during such year and subsequent years with respect to films as to which filming begins within such year by

(*b*) The percentage which, based on the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made, the annual gross receipts (as described in § 1.993-6(a)(1), whether or not such films constitute property described therein) of such other film makers from the sale or lease of such films outside the United States is of the annual gross receipts of such other film makers from all sales or leases of such films.

(2) *Purpose of loan.* A loan by a DISC will be deemed to be for the making of a film if there exists a written agreement between the DISC and the borrower, executed at or before the time the loan is made, stating that the loan is made or to be made to enable the borrower to make such film.

(3) *Reasonable estimate of amounts.* For purposes of subparagraph (1)(iii)(*a*)(*2*) of this paragraph, a reasonable estimate shall be based on the conditions known by the DISC and borrower to exist at the time a loan is made (or which the DISC and borrower have reason to know to exist at such time).

(4) *Experience of film makers.* For purposes of subparagraph (1)(iii)(*b*) of this paragraph, the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made shall be derived from such records and statistics as are acknowledged in the trade as reasonably reliable.

(5) *Domestic film maker.* For purposes of this section, a borrower is a domestic film maker with respect to a film if—

(i) The borrower is a U.S. person within the meaning of section 7701(a)(30), except that (*a*) with respect to a partnership all of the partners must be U.S. persons and (*b*) with respect to a corporation all of its officers and at least a majority of its directors must be U.S. persons,

(ii) The borrower is engaged in the trade or business of making the film with respect to which the loan is made,

(iii) Each studio, if any, used or to be used for filming or for recording sound incorporated into such film is located in the United States (as defined in section 7701(a)(9)),

(iv) At least 80 percent of the aggregate playing time of the film is or will be photographed within the United States (as defined in section 7701(a)(9)), and

(v) At least 80 percent of the total amount (not including any amount which is contingent upon receipts or profits of such film and which is fully taxable by the United States) paid or to be paid for services performed in the making of the film is either paid or to be paid to persons who are U.S. persons at the time such services are performed or consists of amounts which are fully taxable by the United States.

(6) *Amounts as fully taxable.* For purposes of subparagraph (5)(v) of this paragraph, an amount is considered fully taxable by the United States if the entire amount is included in gross income under section 61 or is subject to withholding under any provision of U.S. law or treaty to which the U.S. is a party and is not exempt from taxation under any provision of such law or treaty. Where a nonresident alien individual is engaged for the making of a film or where a foreign corporation is engaged to furnish the services of one of its officers or employees for the making of a film, the amount paid such individual or corporation will be considered as fully taxable by the United States only if it meets the test of this subparagraph.

[T.D. 7514, 42 FR 55464, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57311, Nov. 2, 1977; T.D. 7514, 42 FR 60910, Nov. 30, 1977]

§ 1.993-5 Definition of related foreign export corporation.

(a) *General rule*—(1) *Definition.* Under section 993(e), a foreign corporation is a related foreign export corporation with respect to a DISC if—

(i) It is a foreign international sales corporation described in paragraph (b) of this section,

(ii) It is a real property holding company described in paragraph (c) of this section, or

(iii) It is an associated foreign corporation described in paragraph (d) of this section.

(2) *Application of this section.* It is necessary to determine whether a foreign corporation is a related foreign export corporation with respect to a DISC for the following two purposes:

(i) *Qualified export assets.* Under § 1.993-2(g), the stock or securities of a related foreign export corporation held by the DISC are qualified export assets.

(ii) *Qualified export receipts.* Under § 1.993-1 (e), (f), and (g), certain receipts of the DISC with respect to stock or securities of a related foreign export corporation held by the DISC are qualified export receipts.

(b) *Foreign international sales corporation*—(1) *In general.* A foreign corporation is a foreign international sales corporation with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of § 1.957-1(b) (relating to definition of controlled foreign corporation),

(ii) 95 percent or more of such foreign corporation's gross receipts (as defined in § 1.993-6) for its taxable year ending with or within such taxable year of the DISC consists of qualified export receipts described in § 1.993-1 (b) through (e) or interest described in § 1.993-1(g) derived from any obligations described in § 1.993-2 (d) or (e), and

(iii) The sum of the adjusted bases of the assets of the foreign corporation which are qualified export assets described in § 1.993-2 (b) through (e) and which are held by the foreign corporation at the close of its taxable year which ends with or within such taxable year of the DISC equals or exceeds 95 percent of the sum of the adjusted bases of all assets held by the foreign corporation at the close of such taxable year.

(2) *Certain determinations.* The determinations as to whether gross receipts are qualified export receipts described in subparagraph (1)(ii) of this paragraph and as to whether assets are qualified export assets described in subparagraph (1)(iii) of this paragraph are made by applying the requirements of §§ 1.993-1 and 1.993-2 to the foreign corporation as if it were a domestic corporation being tested to determine whether it is a DISC. For purposes of making either of such determinations, the principles of accounting applicable for purposes of computing earnings and profits under § 1.964-1 (relating to a controlled foreign corporation's earnings and profits) shall apply.

(c) *Real property holding company*—(1) *In general.* A foreign corporation is a real property holding company with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of § 1.957-1(b) and

(ii) The sole function of the foreign corporation is to hold title to real property situated outside the United States for the exclusive use of the DISC, title to which may not be held by the DISC (and, if the DISC subleases such property to a related supplier, as described in subparagraph (3) of this paragraph, by such related supplier) under the law of the country in which such property is situated.

(2) *Activities of the foreign corporation.* For purposes of subparagraph (1)(ii) of this paragraph, a foreign corporation which holds title to real property situated outside the United States may also perform activities with respect to such property (such as management, maintenance, and payment of taxes) which are ancillary to its function of holding title to such property.

(3) *Exclusive use by the DISC.* Real property held by the foreign corporation must be used exclusively by the DISC whether under a lease or any other arrangement. Real property is not so used by the DISC if the DISC subleases such property to any other person. If, however, during a taxable year of the DISC—

(i) 90 percent or more of the qualified export receipts of the DISC for such year are derived from transactions with respect to which it is a commission agent for a related supplier (as defined in § 1.994-1(a)(3)(ii)), and

(ii) The DISC subleases such property to such related supplier

then such property will be considered as used exclusively by the DISC during such year if such related supplier does not sublease such property.

(d) *Associated foreign corporation*—(1) *In general.* A foreign corporation is an associated foreign corporation with respect to a taxable year of the DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC, or one or more members of the same controlled group of corporations (as defined in subparagraph (2) of this paragraph) as the DISC, owns (within the meaning of section 1563 (d) and (e)) stock of the foreign corporation possessing less than 10 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote, as determined under the principles of § 1.957-1(b), or owns no stock of such corporation, and

(ii) The ownership of stock, or of securities (as defined in § 1.993-2(g)), of the foreign corporation by the DISC or by one or more members of such controlled group of corporations reasonably furthers a transaction or transactions giving rise to qualified export receipts for the DISC.

(2) *Controlled group of corporations.* For purposes of this paragraph, the term "controlled group of corporations" has the same meaning assigned to the term in section 1563(a) and not section 993(a)(3) and § 1.993-1(k). Thus, for purposes of this paragraph, the test of control is 80 percent control and, since the rules of section 1563(b) apply, only domestic members are considered to be members of the controlled group.

(3) *Furtherance of qualified export receipts.* Ownership of stock or securities of a foreign corporation will be considered as reasonably furthering a transaction or transactions giving rise to qualified export receipts for a DISC if—

(i) The ownership is necessary to obtain or maintain the foreign corporation as a customer of the DISC or of a related supplier, as defined in § 1.994-1(a)(3)(ii) of the DISC or to aid the sales distribution system of the DISC or of such related supplier, and

(ii) The amount of the investment in the foreign corporation bears a reasonable relationship to the amount of the DISC's annual net profit from transactions in its trade or business which it may reasonably expect to derive on account of such ownership.

In determining whether the amount of the investment is reasonable, there shall be taken into account any stock or securities of the foreign corporation owned by any other foreign corporation which, if it were a domestic corporation, would be a member of the same controlled group of corporations as the DISC.

[T.D. 7514, 42 FR 55467, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977]

§ 1.993-6 Definition of gross receipts.

(a) *General rule.* Under section 993(f), for purposes of sections 991 through 996, the gross receipts of a person for a taxable year are—

(1) The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and

(2) Gross income recognized from all other sources, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subparagraph (1) of this paragraph),

(ii) Dividends and interest,

(iii) The sale at a gain of any property not described in subparagraph (1) of this paragraph, and

(iv) Commission transactions as and to the extent described in paragraph (e) of this section.

(b) *Nongross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) The proceeds of a loan or of the repayment of a loan, or

(2) A receipt of property in a transaction to which section 118 (relating to contribution to capital) or 1032 (relating to exchange of stock for property) applies.

(c) *Nonreduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by returns and allowances, costs of goods sold, expenses, losses, a deduction for dividends received under section 243, or any other deductible amounts.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a DISC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the DISC for the taxable year for which such amount is included in the gross income of the DISC.

(e) *Commission transactions.* (1) In the case of transactions which give rise to a commission on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the commission agent as gross income from all such transactions shall be the gross receipts derived by the principal from the sale or lease of the property, or the gross income derived by the principal from the furnishing of services, with respect to which the commissions are derived. In the case of a commission agent for a related supplier (as defined in § 1.994-1(a)(3)(ii)), the gross receipts or gross income of such agent shall be determined as if it used the same method of accounting as its related supplier. In the case of a commission agent for a principal other than a related supplier, the gross receipts or gross income of such principal shall be determined as if such principal used the same method of accounting as its agent.

(2) If the commission arrangement provides that the commission agent will receive a commission only with respect to sales or leases of export property, or the furnishing of services, which result in qualified export receipts, the commission agent will not take into account the gross receipts or gross income, as the case may be, derived by the principal from any transaction for which the commission agent would not be entitled to a commission under the commission arrangement.

(f) *Example.* The provisions of this section may be illustrated by the following example:

Example. During 1973, M, a related supplier (as defined in § 1.994-1(a)(3)(ii)) of N, is engaged in the manufacture of machines in the United States. N, a calendar year taxpayer, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of such machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it in a related foreign export corporation (as defined in § 1.993-5), interest on producer's loans made to M, and proceeds from sales of business assets located outside the United States resulting in a recognized gains and losses. N's gross receipts for 1973 are $3,550, computed on the basis of the additional facts assumed in the table below:

(1) N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses)	$1,500
(2) N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses)	500
(3) N's gross income from services for machines manufactured by M (without reduction for service expenses)	400
(4) Z's sale receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales, and commission sales expenses)	550
(5) Dividends received by N	150
(6) Interest received by N on producer's loans	200
(7) Proceeds received by N representing recognized gain (but not losses) from sales of business assets located outside the United States	250
(8) N's gross receipts	3,550

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

§ 1.993-7 Definition of United States.

Under section 993(g), the term "United States" includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and possessions of the United States. For the requirement that a DISC must be incorporated and existing under the laws of a State or the District of Columbia, see § 1.992-1(a)(1).

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

§ 1.994-1 Inter-company pricing rules for DISC's.

(a) *In general*—(1) *Scope.* In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c) (2), (3), and (4) of this section: The "4 percent" gross receipts method, the "50-50" combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain "incomplete transactions" and for computing combined taxable income, see paragraph (c) (5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c)(7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e)(1) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e)(3) of this section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e)(4) of this section. Export promotion expenses are defined in paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994-2 prescribes the marginal costing rules authorized by section 994(b)(2).

(2) *Relationship to section 993.* If the minimum requirements of paragraph (1) of § 1.993-1 that must be met for a DISC to be subject to section 994 have been satisfied, the application of section 994(a) (1) or (2) does not depend on the extent to which the

DISC performs substantial economic functions, except with respect to export promotion expenses.

(3) *Related party and related supplier.* For the purposes of this section—

(i) The term "related party" means a person which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482 and § 1.482-1(a).

(ii) The term "related supplier" means a related party which singly engages in a transaction directly with the DISC which is subject to the rules of section 994 and this section. However, a DISC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of Z, a DISC, and sells a product to Y which is resold to Z, only Y is the related supplier of Z, and, thus, only the resale from Y to Z is subject to section 994 and this section. If, however, X sells directly to Z and Y also sells directly to Z, then, as to the transactions involving direct sales to Z, each of X and Y is a related supplier of Z.

(b) *Transactions to which section 994 applies.* Section 994(a)(3) may be applied, as described in paragraph (a) of this section, to any transaction between a related supplier and a DISC. Section 994(a) (1) or (2) may be applied, as described in paragraph (a) of this section, to a transaction between a related supplier and a DISC only in the following cases:

(1) Where the related supplier sells export property to the DISC for resale or where the DISC is commission agent for the related supplier on sales by the related supplier of export property to third parties whether or not related parties. For purposes of this section, references to sales include exchanges.

(2) Where the related supplier leases export property to the DISC for sublease for a comparable period with comparable terms of payment or where the DISC is commission agent for the related supplier on leases by the related supplier of export property to third parties whether or not related parties.

(3) Where services are furnished by a related supplier which are related and subsidiary to any sale or lease by the DISC, acting as principal or commission agent, of export property under subparagraph (1) or (2) of this paragraph.

(4) Where engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by a related supplier where the DISC is acting as principal or commission agent with respect to the furnishing of such services to a third party whether or not a related party.

(5) Where the related supplier furnishes managerial services in furtherance of the production of qualified export receipts of an unrelated DISC where the related DISC is acting as principal or commission agent with respect to the furnishing of such services to an unrelated DISC.

Transactions are included, for purposes of this paragraph, only if they give rise to qualified export receipts (within the meaning of section 993(a)) in the hands of the related DISC. If a transaction is not included in subparagraph (1), (2), (3), (4), or (5) of this paragraph, the rules of section 994(a) (1) or (2) do not apply. Thus, for example, the rules of sectoin 994(a) (1) or (2) would not apply if a DISC purchased export property from its related supplier and leased such property to a third party.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) *The "4-percent" gross receipts method.* Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) *The "50-50" combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) *Section 482 method.* If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a transaction or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year—

(*a*) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year,

(*b*) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6)(ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(*c*) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under (*b*) of this subdivision.

(*d*) The time and manner of payment of transfer prices required by (*b*) and (*c*) of this subdivision shall be determined under paragraph (e) (3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6)(ii) of this paragraph).

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining the gross receipts of the DISC and the total

costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See § 1.991-1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (*a*) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (*b*) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of § 1.993-1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

(7) *Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (*a*) A recognized industry or trade usage, or (*b*) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(d) *Rules under section 994(a) (1) and (2) for transactions other than sales.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales:

(1) *Leases.* In the case of a lease of export property by a related supplier to a DISC for sublease by the DISC to produce gross receipts, for any taxable year the amount of rent the DISC

must pay to the related supplier shall be determined under the DISC's lease with its related supplier but must be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. For purposes of applying this subparagraph, transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(7) of this section as to combine in any one group of transactions both lease transactions and sale transactions involving the same product or product line.

(2) *Commissions.* If any transaction to which section 994 applies is handled on a commission basis for a related supplier by a DISC and such commissions give rise to qualified export receipts under section 993(a)—

(i) The amount of the income that may be earned by the DISC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the DISC would have been permitted to earn under the gross receipts method, the combined taxable income method, or section 482 method if the related supplier had sold (or leased) the property or service to the DISC and the DISC in turn sold (or subleased) to a third party, whether or not a related party, and

(ii) The maximum commission the DISC may charge the related supplier is the sum of the amount of income determined under subdivision (i) of this subparagraph plus the DISC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(3) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the DISC and its related supplier and the accounting method otherwise employed by the DISC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* In the case of related and subsidiary services to which subdivision (i) of this subparagraph does not apply and other services described in paragraph (b) (4) or (5) of this section performed by a related supplier (relating respectively to engineering and architectural services and certain managerial services), the amount of taxable income which the DISC may derive for any taxable year shall be determined under the arrangement between the DISC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the gross receipts method or combined taxable income method. Related and subsidiary services to which subdivision (i) of this subparagraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(7) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the product or product lines were sold or in which payment for such services is received or accrued. The rules for grouping of transactions in paragraph (c)(7) of this section shall not apply with respect to the determination of taxable income which the DISC may derive from other services described in paragraph (b) (4) or (5) of this section performed by a related supplier or commissions on such services, and such determination shall be made only on a transaction-by-transaction basis.

(e) *Methods of applying paragraphs (c) and (d) of this section*—(1) *Limitation on DISC income ("no loss" rule)*—(i) *In general.* Except as otherwise provided in this subparagraph, neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

(ii) *Special rule for applying "4 percent" gross receipts method to sales.* A transfer price or commission, determined under the "4 percent" gross receipts method (determined without regard to subdivision (i) of this subparagraph), for a sale of export property referred to in paragraph (b)(1) of this section, will not be considered to cause a loss for the related supplier if for the DISC's taxable year, the ratio that (*a*) the taxable income of the DISC derived from such sale by using such price or commission bears to (*b*) the DISC's gross receipts from such sale is not greater than the ratio that (*c*) all of the taxable income of the related supplier and the DISC from all sales of the same product or product line (domestic and foreign) to third parties whether or not related parties bears to (*d*) the total gross receipts of the related supplier and the DISC from such sales. For purposes of the preceding sentence, sales between the DISC and its related suppliers shall not be taken into account under (*c*) or (*d*) of this subdivision. For example, assume that for a taxable year of a DISC the total costs of the related supplier and the DISC with respect to all sales ($150 for domestic and $44 for foreign) of a product line are $194 and the total gross receipts of the related supplier and the DISC with respect to such sales are $200 so that the total taxable income of the related supplier and the DISC with respect to such sales is $6. The parties would thus be entitled to compute a transfer price determined under the gross receipts method on any given sale of product A of such product line by the related supplier to the DISC which would allocate to the DISC taxable income equal to not more than 3 percent (*i.e.,* $6/$200) of its gross receipts derived from its resale of such product. If the DISC were to resell an item of product A for $10, the transfer price paid by the DISC to the related supplier determined under the gross receipts method could be as low as $9.70.

(iii) *Grouping transactions.* For purposes of subdivision (i) of this subparagraph, the basis for grouping transactions chosen by the taxpayer under paragraph (c)(7) of this section for the taxable year shall be applied. For purposes of making the computations of subdivision (ii) (*c*) and (*d*) of this subparagraph, however, the taxpayer may choose any basis for grouping transactions permissible under paragraph (c)(7) of this section, even though it may not be the same basis as that already chosen under paragraph (c)(7) of this section for computing transfer prices or commissions to a DISC. If, for example, the taxpayer has chosen to group transactions on a product basis for computing transfer prices or commissions to a DISC for a taxable year, the taxpayer may still group transactions on a product line basis for purposes of computing taxable income and total gross receipts under subdivision (ii) (*c*) and (*d*) of this subparagraph. For a further example, if the taxpayer computes taxable income for one group of transactions under the gross receipts method and computes taxable income for a second group of transactions under the combined taxable income method, the taxpayer may aggregate these transactions for purposes of computing taxable income and total gross receipts under subdivision (ii) (*c*) and (*d*) of this subparagraph.

(2) *Relationship to section 482.* In applying the rules under section 994, it may be necessary to first take into account the price of a transfer (or other transaction) between the DISC (or related supplier) and a related party which is subject to the arm's length standard of section 482. Thus, for example, where a related supplier sells export property to a DISC which the related supplier purchased from related parties, the costs taken into account in computing the combined taxable income of the DISC and the related supplier are determined after any necessary adjustment under section

482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a DISC, however, the DISC and its related supplier are treated as if they were a single entity carrying on all the functions performed by the DISC and the related supplier with respect to the transaction and the DISC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no DISC.

(3) *Initial payment of transfer price or commission.* (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of § 1.992-1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under § 1.993-2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or exceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see § 1.993-2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv)(*a*) Except with respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(*b*) With respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(*1*) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's cost of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(*2*) If the transaction is completed by the date on which the DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(*3*) The percentage that (*i*) an amount equal to (*a*) the amount actually paid by the DISC to the related supplier in respect of the property minus (*b*) the related supplier's cost of goods sold with respect to the property, bears to (*ii*) the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that (*iii*) the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to (*iv*) the cost of goods sold of the related supplier and DISC with respect to such transactions.

(*c*) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c) (5) and (7) of this section.

(v) An indebtedness arising under subdivision (iii) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the 61st day after the close of the DISC's taxable year in which the transaction occurred which gave rise to the indebtedness to the date of payment. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid.

(4) *Subsequent determination of transfer price or commission.* The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 which affects the amounts which entered into the determination of the transfer price or commission.

(5) *Procedure for adjustments to transfer price or commission.* (i)(*a*) If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price (or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under § 1.993-2(d)(3) as a trade receivable, and thus as a qualified export asset.

(*b*) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000 which price is a reasonable estimate under subparagraph (3)(iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (i.e., $10,000−$8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the transaction occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the account receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under § 1.993-2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receivable or other qualified export asset.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is outstanding.

(v) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (c)(5)(i)(*b*) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, i.e., $8,500 − $8,000, is established on September 15, 1976, the date the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under § 1.993-2(d)(3) for the last day of such year.

Example (2). Assume the same facts as in example (1) except that the account receivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under § 1.993-2(d)(3) for the last day of such year.

(f) *Export promotion expenses*—(1) *Purpose of expense.* (i) In order for an expense or cost of a type described in subparagraph (2) of this paragraph to be an export promotion expense, the expense or cost must be incurred or treated as incurred by the DISC (under subparagraph (7) of this paragraph) to advance the sale, lease, or other distribution of export property for use, consumption, or distribution outside the United States. Costs of services in performing installation (but not assembly) on the site and for meeting warranty commitments if such services are related and subsidiary (within the meaning of § 1.993-1(d)) to any qualified sale, lease, or other distribution of export property by the DISC (or with respect to which the DISC received a commission) will be considered to advance the sale, lease, or other distribution of export property. General and administrative expenses attributable to billing customers, other clerical functions of the DISC, or generally operating the DISC, will also be considered to advance the sale, lease, or other distribution of export property. (ii) Where an expense or cost incurred or treated as incurred by the DISC qualifies only in part as an export promotion expense, such expense or cost must be allocated between the qualified portion and such other portion on a reasonable basis. See § 1.994-2(b)(2) for the option of the related supplier not to claim expenses as export promotion expenses.

(2) *Types of expenses.* The only expenses or costs which may be export promotion expenses are those expenses or costs meeting the test of subparagraph (1) of this paragraph which constitute—

(i) Ordinary and necessary expenses of the DISC paid or incurred during the DISC's taxable year in carrying on any trade or business, allowable as deductions under section 162, such as expenses for market studies, advertising, salaries and wages (including contributions or compensations deductible under section 404) of sales, clerical, and other personnel, rentals on property, sales commissions, warehousing, and other selling expenses,

(ii) A reasonable allowance under section 167 for exhaustion, wear and tear, or obsolescence of the property of the DISC,

(iii) Costs of freight (subject to the limitations of subparagraph (4) of this paragraph),

(iv) Costs of packaging for export (as defined in subparagraph (5) of this paragraph), or

(v) Costs of designing and labeling packages exclusively for export markets (under subparagraph (6) of this paragraph).

(3) *Ineligible expenses.* Items ineligible to be export promotion expenses include, for example, interest expenses, bad debt expenses, freight insurance, State and local income and franchise taxes, the cost of manufacture or assembly operations, and items of cost of goods sold (except as otherwise provided in this paragraph in the case of certain freight, packaging, and designing and labeling expenses). Income or similar taxes eligible for a foreign tax credit under sections 901 and 903 are also not eligible to be export promotion expenses.

(4) *Freight expenses*—(i) *In general.* Export promotion expenses include one-half of the freight expense (not including insurance) for shipping export property aboard a U.S.-flag carrier in those cases where law or regulation of the United States or of any State or political subdivision thereof or of any agency or instrumentality of any of these does not require that the export property be shipped aboard a U.S.-flag carrier. For purposes of this paragraph, the term "freight expense" includes charges paid for c.o.d. service, miscellaneous ground charges, such as charges incurred for services normally performed by U.S.-flag carriers, charges for services of loading aboard U.S.-flag carriers normally performed by such carriers, freight forwarders, or independent contractors engaged in loading property, and charges attributable to a freight consolidation function normally performed by freight forwarders. In order for one-half of freight expenses paid to the owner (or the agent of the owner) of a U.S.-flag carrier to be claimed as an export promotion expense, the DISC must obtain a written statement (such as, for example, a bill of lading) from the owner (or the agent) disclosing that the export property was shipped aboard the owner's U.S.-flag carrier or another U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the owner (or the agent). For the requirement of a written statement from a freight forwarder, see subdivision (iv) of this subparagraph.

(ii) *U.S.-flag carrier defined.* For purposes of this paragraph, the term "U.S.-flag carrier" is an airplane owned and operated by a U.S. person or persons (as defined in section 7701(a)(30)) or a ship documented under the laws of the United States. Shipment initiated by delivery to the U.S. Postal Service shall be considered shipment aboard a U.S.-flag carrier, but not if shipped to a place to which mail shipments from the United States are ordinarily accomplished by land transportation, such as to Canada or Mexico, unless airmail is specified.

(iii) *Shipment pursuant to law or regulation.* Shipment pursuant to law or regulation includes instances where a U.S.-flag carrier must be used in order to obtain permission from the Government to make the export. If the law or regulation requires a fixed portion of the export property to be shipped aboard a U.S.-flag carrier, the freight expense on that portion of such export property that was so shipped in order to satisfy such requirement cannot qualify as an export promotion expense.

(iv) *Freight forwarders.* A payment to a freight forwarder shall be considered freight expense within the meaning of this paragraph to the extent the forwarder utilizes a U.S.-flag carrier. For purposes of this paragraph, the term "freight forwarder" includes air freight consolidators and carriers owned and operated by U.S. persons utilizing U.S.- flag carriers such as non-vessel-owning common carriers. In order for one-half of freight expenses paid to a freight forwarder to be claimed as export promotion expenses, the DISC must obtain a written statement (such as, for example, a bill of lading) from the freight forwarder disclosing that the export property was shipped aboard a U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the freight forwarder.

(v) *Freight within the United States.* A DISC may not claim as export promotion expense any amount that is attributable to carriage of export property between points within the United States. If, however, export property is carried from the United States to a foreign country on a through shipment pursuant to a single bill of lading or similar document aboard one or more U.S.-flag carriers, the freight expense of such carriage shall not be apportioned between the domestic and foreign portions of such carriage, even though a carrier may stop en route within the United States or the export property may be shifted from one carrier to another, and one-half of such freight expense may be claimed as an export promotion expense. Freight expense does not include the cost of transporting the export property to the depot of the U.S.-flag carrier or freight forwarder for shipment abroad. The expense of shipment of export property initiated by delivery to the U.S. Postal Service for ultimate delivery outside the United States shall be considered as attributable entirely to carriage of such property outside the United States.

(5) *Packaging for export.* (i) Export promotion expenses include the direct and indirect cost of packaging export property (including the cost of the package) for export whether or not the packaging is the same as domestic packaging. Such packaging costs do not include costs of manufacturing (as defined in the regulations under section 993) and assembly. Thus, if a DISC buys and packages export property for resale, its costs of packaging the export property are export promotion expenses. If, however, the process of such packaging by the DISC is physically integrated with the process of manufacturing the export property by the related supplier, the costs of such packaging are not export promotion expenses.

(ii) The cost of containers leased from a shipping company to which the DISC also pays freight for the property packaged is not a cost of packaging. However, in such circumstances, one-half of the rental charge may be allowable as a freight expense if permitted under subparagraph (4) of this paragraph.

(6) *Designing and labeling packages.* Export promotion expenses include the direct and indirect costs of designing and labeling packages, including bottles, cans, jars, boxes, cartons, or containers, to the extent incurred for export markets. Thus, for example, to the extent incurred for supplying export markets, the cost of designing labels in a foreign language and the cost of printing such labels are export promotion expenses.

(7) *DISC must incur export promotion expenses*—(i) *In general.* In order for an expense to be an export promotion expense it must be incurred or treated as incurred under this subparagraph by the DISC. For example, an expense is incurred by a DISC if the expense results from (*a*) the DISC incurring an obligation to pay compensation to its employees, (*b*) depreciation of property owned by the DISC and used by its employees, (*c*) the DISC incurring an obligation to pay for office supplies used by its employees, (*d*) the DISC incurring an obligation to pay space costs for use by its employees, or (*e*) the DISC incurring

an obligation to pay other costs supporting efforts by its employees.

(ii) *Payments to independent contractors.* A payment to an independent contractor, directly or indirectly, is treated as incurred by the DISC if the cost of performing the function performed by the independent contractor would be considered an export promotion expense described in subparagraphs (1) and (2) of this paragraph if performed by the DISC, and if, in a case where the services of the independent contractor were engaged by a party related to the DISC, such related party and such DISC agreed in writing before the contract was entered into that a specified portion or all of the contract was for the benefit of the DISC and that all of the expenses of the contract (eligible to be considered as export promotion expenses) with respect to such portion would be borne by the DISC.

(iii) *Expenses incurred by related parties.* Reimbursements or other payments by a DISC to a related party are export promotion expenses only if the expenses of the related party for which reimbursement is made are for space in a building actually used by employees of the DISC or for export property owned by the DISC. Except as otherwise provided in the preceding sentence, expenses incurred by a foreign international sales corporation (FISC) or a real property holding company (as defined in section 993(e) (1) and (2), respectively) shall not be treated as export promotion expenses of its DISC.

(iv) *Selling commissions paid by a DISC.* A commission paid by a DISC to a person other than a related person, with respect to a transaction which gives rise to qualified export receipts of the DISC, is an export promotion expense of the DISC. A commission paid by a DISC to a related person is not an export promotion expense.

(v) *Sales of promotional material.* If a DISC sells promotional material to a buyer of export property from the DISC at a price which is greater than the costs of the DISC for such material, such costs are not export promotion expenses. If, however, the DISC sells promotional material at a price which is less than its costs for such material, the excess of such costs over such price is an export promotion expense. For rules relating to the status of promotional material as qualified export assets and export property, see § 1.993-2 and § 1.993-3, respectively.

(vi) An expense may be incurred by the DISC under subdivisions (i) through (v) of this subparagraph even if the accounting for and payment of such expense is handled by a related party and the DISC reimburses the related party for such expenses.

(8) *Incomplete transactions.* Expenses eligible to be treated as export promotion expenses which are attributable to the sale, lease, or other distribution of export property and which are incurred prior to the taxable year of sale, lease, or other distribution by the DISC are not treated as export promotion expenses until the taxable year of sale, lease, or other distribution or until the taxable year in which it is first determined that no transaction is reasonably expected to result from the expense incurred (whether or not a transaction subsequently results). Thus, for example, if a DISC incurs a packaging cost which is otherwise eligible to be treated as an export promotion expense, the DISC may not include such charge as an export promotion expense until the year in which the export property with respect to which the packaging cost was incurred is actually sold by the DISC. If no transaction is reasonably expected to result from the packaging cost, such cost should be allocated as an export promotion expense to the group of transactions to which such cost is most closely related.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). J and K are calendar year taxpayers. J, a domestic manufacturing company, owns all the stock of K, a DISC for the taxable year. During 1972, J manufactures only 100 units of a product (which is eligible to be export property as defined in section 993(c)). J enters into a written agreement with K whereby K is granted a sales franchise with respect to exporting such property and K will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold for $1,000. J's cost of goods sold attributable to the 100 units is $650. J's direct selling expenses so attributable are $100. Although J has other deductible expenses, for purposes of this example assume that J has no other deductible expenses. K pays $230 to independent contractors which qualify as export promotion expenses under paragraph (f)(7)(ii) of this section. K does not perform functions substantial enough to entitle it to an allocation of income which meets the arm's length standard of section 482. The income which K may earn under section 994 under the franchise is $20, computed as follows:

(1) Combined taxable income:		
(a) K's sales price		$1,000
(b) Less deductions:		
J's cost of goods sold	$650	
J's direct selling expenses	100	
K's export promotion expenses	230	
Total deductions		980
(c) Combined taxable income		20
(2) K's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		10
(b) Plus: 10 percent of K's export promotion expenses (10% of $230)		23
(c) K's profit		33
(3) K's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of K's sales price (4% of $1,000)		40
(b) Plus: 10 percent of K's export promotion expenses (10% of $230)		23
(c) K's profit		63

Since combined taxable income ($20) is lower than both K's profit under the combined taxable income method ($33) and under the gross receipts method ($63), the maximum income K may earn is $20. Accordingly, the commissions K may receive from J are $250, *i.e.*, K's expenses ($230) plus K's profit ($20).

Example (2). M and N are calendar year taxpayers. M, a domestic manufacturing company, owns all the stock of N, a DISC for the taxable year. During 1972, M produces and sells a particular product line of export property to N for $75, a price which can be justified as satisfying the standard of arm's length price of section 482. N performs substantial functions with respect to the transaction and resells the export property for $100. M's cost of goods sold attributable to the export property is $60. M's direct selling expenses so attributable (relating to advertising of the product line in foreign markets) are $12. Although M has other deductible expenses, for purposes of this example, assume that M has no other deductible expenses. N's expenses attributable to resale of the export property are $22 of which $20 are export promotion expenses. The maximum profit which N may earn with respect to the product line is $6, computed as follows:

(1) Combined taxable income:		
(a) N's sales price		$100
(b) Less deductions:		
M's cost of goods sold	$60	
M's direct selling expenses	12	
N's expenses	22	
Total deductions		94
(c) Combined taxable income		6
(2) N's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		3
(b) Plus: 10 percent of N's export promotion expenses (10% of $20)		2
(c) N's profit		5
(3) N's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of N's sales price (4% of $100)		4
(b) Plus: 10 percent of N's export promotion expenses (10% of $20)		2
(c) N's profit		5
(4) N's profit under section 482 method:		
(a) N's sales price		100
(b) Less deductions:		
N's cost of goods sold (price paid by N to M)	75	
N's expenses	22	
Total deductions		97
(c) N's profit		3

Since the gross receipts method results in greater profit to N ($6) than does the combined taxable income method ($5) or section 482 method ($3), and does not exceed combined taxable income ($6), N may earn a maximum profit of $6. Accordingly, the transfer price from M to N may be readjusted as long as the transfer price is not readjusted below $72, computed as follows:

(5) Transfer price from M to N:		
(a) N's sales price		$100
(b) Less:		
N's expenses	$22	
N's profit	6	
Total subtractions		28
(c) Transfer price		72

Example (3). Q and R are calendar year taxpayers. Q, a domestic manufacturing company, owns all the stock of R, a DISC for the taxable year. During 1972, Q produces and sells a product line of export property to R for $170, a price which can be justified as satisfying the standards of arm's length price of section 482, and R resells the export property for $200. Q's cost of goods sold attributable to the export property is $115 so that the combined gross income from the sale of the export property is $85 (*i.e.*, $200 minus $115). Q's expenses incurred in connection with the property sold are $35. Q's deductible overhead and other supportive expenses allocable to all gross income are $6. Apportionment of these supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. Q's gross income from sources other than the transaction is $170 making total gross income of Q and R (excluding the transfer price paid by R) $255 (i.e., $85 plus $170). R's expenses attributable to resale of the export property are $20, all of which are export promotion expenses. The maximum profit which R may earn with respect to the product line is $16, computed as follows:

(1) Combined taxable income:			
(a) R's sales price			$200
(b) Less deductions:			
(i) Q's cost of goods sold		115	
(ii) Q's expenses incurred in connection with the property sold		35	
(iii) Apportionment of Q's supportive expenses:			
Q's supportive expenses	$6		
Combined gross income from sale of export property	85		
Total gross income of Q and R	255		
Apportionment	(6×85)/255	2	
(iv) R's expenses		20	
Total deductions			172
(c) Combined taxable income			28
(2) R's profit under combined taxable income method (before application of loss limitation):			
(a) 50 percent of combined taxable income			14
(b) Plus: 10 percent of R's export promotion expenses (10% of $20)			2
(c) R's profit			16
(3) R's profit under gross receipts method (before application of loss limitation):			
(a) 4 percent of R's sales price (4% of $200)			8
(b) Plus: 10 percent of R's export promotion expenses (10% of $20)			2
(c) R's profit			10
(4) R's profit under section 482 method:			
(a) R's sales price			200
(b) Less deductions:			
R's cost of goods sold (price paid by R to Q)		170	
R's expenses		20	
Total deductions			190
(c) R's profit			10

Since the combined taxable income method results in greater profit to R ($16) than does the gross receipts method ($10) or section 482 method ($10), and does not exceed combined taxable income ($28), R may earn a maximum profit of $16. Accordingly, the transfer price from Q to R may be readjusted as long as the transfer price is not readjusted below $164 computed as follows:

(5) Transfer price from Q to R:		
(a) R's sales price		$200
(b) Less:		
R's expenses	$20	
R's profit	16	
Total		36
(c) Transfer price		164

Example (4). S and T are calendar year taxpayers. S, a domestic manufacturing company, owns all the stock of T, a DISC for the taxable year. During 1972, S produces and sells 100 units of a particular product to T under a written agreement which provides that the transfer price between S and T shall be that price which allocates to T the maximum permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold by T for $950. S's cost of goods sold attributable to the 100 units is $650. S's other deductible expenses so attributable are $300. Although S has other deductible expenses, for purposes of this example, assume that S has no deductible expenses not definitely allocable to any item of gross income. T's expenses attributable to the resale of the 100 units are $50. S chooses not to apply the section 482 method. T may not earn any income under the gross receipts or combined taxable income method with respect to resale of the 100 units because combined taxable income is a negative figure, computed as follows:

(1) Combined taxable income:		
(a) T's sales price		$950
(b) Less deductions:		
S's cost of goods sold	$650	
S's expenses	300	
T's expenses	50	
Total deductions		1,000
(c) Combined taxable income (loss)		($50)

Under paragraph (e)(1)(i) of this section, T is permitted to recover its expenses attributable to the 100 units ($50) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from S to T may be readjusted as long as the transfer price is not readjusted below $900, computed as follows:

(2) Transfer price from S to T:		
(a) T's sales price		$950
(b) Less: T's expenses		50
(c) Transfer price		900

Example (5). Assume the same facts as in example (4) except that S chooses to apply the section 482 method and that under arm's length dealings T would have derived $10 of income. Accordingly, the transfer price from S to T may be set at an amount not less than $890, computed as follows:

(1) Transfer price from S to T:		
(a) T's sales price		$950
(b) Less:		
T's expenses	$50	
T's profit	10	
Total deductions		60
(c) Transfer price		890

Example (6). X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During March 1972, X manufactures a particular product of export property which it leases on April 1, 1972, to Y for a term of 1 year at a monthly rental of $1,000, a rent which satisfies the standard of arm's length rental under section 482. Y subleases the product on April 1, 1972, for a term of 1 year at a monthly rental of $1,200. X's cost for the product leased is $40,000. X's other deductible expenses attributable to the product are $900, all of which are incurred in 1972. Although X has other deductible expenses, for purposes of this example, assume that X has no other deductible expenses. Y's expenses attributable to sublease of the export property are $450, all of which are incurred in 1972 and are export promotion expenses. X depreciates the property on a straight line basis without the use of an averaging convention, assuming a useful life of 8 years and no salvage value. The profit which Y may earn with respect to the transaction is $2,895 for 1972 and $1,175 for 1973, computed as follows:

COMPUTATION FOR 1972

(1) Combined taxable income:		
(a) Y's sublease rental receipts for year ($1,200×9 months)		$10,800
(b) Less deductions:		
X's depreciation ($40,000×1/8×9/12)	$3,750	
X's other expenses	900	
Y's expenses	450	
Total deductions		5,100
(c) Combined taxable income		5,700
(2) Y's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		2,850
(b) Plus: 10 percent of Y's export promotion expenses (10% of $450)		45
(c) Y's profit		2,895
(3) Y's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of Y's sublease rental receipts for year (4% of $10,800)		432
(b) Plus: 10 percent of Y's export promotion expenses (10% of $450)		45
(c) Y's profit		477
(4) Y's profit under section 482 method:		
(a) Y's sublease rental receipts for year		$10,800
(b) Less deductions:		
Y's lease rental payments for year	$9,000	
Y's expenses	450	
Total deductions		9,450
(c) Y's profit		1,350

Since the combined taxable income method results in greater profit to Y ($2,895) than does the gross receipts method ($477) or section 482 method ($1,350), Y may earn a profit of $2,895 for 1972. Accordingly, the monthly rental payable by Y to X for 1972 may be readjusted as long as the monthly rental payable is not readjusted below $828.33, computed as follows:

(5) Monthly rental payable by Y to X for 1972:		
(a) Y's sublease rental receipts for year		$10,800.00
(b) Less:		
Y's expenses	450.00	
Y's profit	2,895.00	
Total		3,345.00
(c) Rental payable for 1972		7,455.00
(d) Rental payable each month ($7,455÷9 months)		828.33

COMPUTATION FOR 1973

(1) Combined taxable income:	
(a) Y's sublease rental receipts for year ($1,200×3 months)	$3,600
(b) Less: X's depreciation ($40,000×1/8×3/12)	1,250
(c) Combined taxable income	2,350
(2) Y's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	$1,175
(b) Y's profit	1,175
(3) Y's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of Y's sublease rental receipts for year (4% of $3,600)	144
(b) Y's profit	144
(4) Y's profit under section 482 method:	
(a) Y's sublease rental receipts for year	3,600

(b) Less: Y's lease rental payments for year	3,000
(c) Y's profit	600

Since the combined taxable income method results in greater profit to Y ($1,175) than does the gross receipts method ($144) or section 482 method ($600), Y may earn a profit of $1,175 for 1973. Accordingly, the monthly rental payable by Y to X for 1973 may be readjusted as long as the monthly rental payable is not readjusted below $808.33, computed as follows:

(5) Monthly rental payable by Y to X for 1973:	
(a) Y's sublease rental receipts for year	$3,600.00
(b) Less: Y's profit	1,175.00
(c) Rental payable for 1973	2,425.00
(d) Rental payable for each month ($2,425 ÷ 3 months)	808.33

[T.D. 7364, 40 FR 29827, July 16, 1975, as amended by T.D. 7435, 41 FR 43142, Sept. 30, 1976]

§ 1.994-2 Marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 994(b)(2). If under paragraph (c)(1) of this section a DISC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in § 1.993-3) from which qualified export receipts are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied to allocate costs between gross receipts derived from such sales and other gross receipts for purposes of computing, under the "50-50" combined taxable income method of § 1.994-1(c)(3), the combined taxable income of the DISC and related supplier derived from such sales. Such marginal costing rules may be applied whether or not the related supplier manufactures, produces, grows, or extracts (within the meaning of § 1.993-3(c)) the export property sold. Such marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or such income is under the exceptions in section 954(b)(4). Such marginal costing rules do not apply to leases of property or the performance of any services whether or not related and subsidiary services (as defined in § 1.994-1(b)(3).

(b) *Marginal costing rules for allocations of costs*—(1) *In general.* Marginal costing is a method under which only marginal or variable costs of producing and selling a particular item, product, or product line are taken into account for purposes of section 994. Where this section is applicable, costs attributable to deriving qualified export receipts for the DISC's taxable year from sales of an item, product, or product line may be determined in any manner the related supplier (as defined in § 1.994-1(a)(3)(ii)) chooses, provided that the requirements of both subparagraphs (2) and (3) of this paragraph are met.

(2) *Variable costs taken into account.* There are taken into account in computing the combined taxable income of the DISC and its related supplier from sales of an item, product, or product line the following costs: (i) Direct production costs (as defined in § 1.471-11(b)(2)(i)) and (ii) costs which are export promotion expenses, but only if they are claimed as export promotion expenses in determining taxable income derived by the DISC under the combined taxable income method of § 1.994-1(c)(3). At the taxpayer's option, all, a part, or none of the costs which qualify as export promotion expenses may be so claimed as export promotion expenses.

(3) *Overall profit percentage limitation.* As a result of such determination of costs attributable to such qualified export receipts for the DISC's taxable year, the combined taxable income of the DISC and its related supplier from sales of such item, product, or product line for the DISC's taxable year does not exceed gross receipts (determined under § 1.993-6) of the DISC derived from such sales, multiplied by the overall profit percentage (determined under paragraph (c)(2) of this section).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* A DISC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which qualified export receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the combined taxable income computed under § 1.994-1(c)(6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the DISC for a product or product line is the percentage which—

(*a*) The combined taxable income of the DISC and its related supplier plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the DISC's taxable year, computed under the full costing method, is of

(*b*) The total gross receipts (determined under § 1.993-6) from all such sales.

(ii) At the annual option of the related supplier, the overall profit percentage for the DISC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i) (*a*) and (*b*) of this subparagraph of the DISC, and all domestic members of the controlled group (as defined in § 1.993-1(k)) of which the DISC is a member, for the DISC's taxable year and for taxable years of such members ending with or within the DISC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) (*b*) and (ii) of this subparagraph, a sale of property between a DISC and its related supplier or between domestic members of the controlled group shall be taken into account only during the DISC's taxable year (or taxable year of the member ending within the DISC's taxable year) during which the property is ultimately sold to a person which is neither the DISC nor such a domestic member.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.994-1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of § 1.994-1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under § 1.994-1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in subdivision (i) of this subparagraph, as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in such subdivision (i).

(4) *Full costing method.* For purposes of this section, the term "full costing method" is the method for determining combined taxable income set forth in § 1.994-1(c)(6).

(d) *Application of limitation on DISC income ("no loss" rule).* If the marginal costing rules of this section are applied, the combined taxable income method of § 1.994-1(c)(3) may not be applied to cause in any taxable year a loss to the related supplier, but such method may be applied to the extent it does not cause a loss. For purposes of the preceding sentence, a loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC determined in accordance with paragraph (b) of this section. If, however, there is no combined taxable income (so determined), see the last sentence of § 1.994-1(e)(1)(i).

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During 1973, X manufactures a product line which is eligible to be export property (as defined in § 1.993-3). X enters into a written agreement with Y whereby Y is granted a sales franchise with respect to exporting such product line from which qualified export receipts will be derived and Y will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Commissions are computed using the combined taxable income method under § 1.994-1(c)(3). For purposes of applying the combined taxable income method, X and Y compute their combined taxable income attributable to the product line of export property under the marginal costing rules in accordance with the additional facts assumed in the table below:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$95.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's DISC taxable income	5.00	
(iv) Total deductions	65.00	
(c) Maximum combined taxable income		30.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):		
(a) Gross receipts of X and Y from all domestic and foreign sales		400.00
(b) Less deductions:		
(i) Direct materials	160.00	
(ii) Direct labor	80.00	
(iii) Other costs (of which $8 are costs of the DISC including $5 of export promotion expenses claimed in determining Y's taxable income)	40.00	
(c) Total deductions		280.00
(d) Total taxable income from all sales computed on a full costing method		120.00
(e) Overall profit percentage (line (d) ($120) divided by line (a) ($400)) (percent)		30%
(f) Multiply by gross receipts from Y's export sales (line (1)(a))		$95.00
(g) Overall profit percentage limitations		28.50

Since the overall profit percentage limitation under line (2)(g) ($28.50) is less than maximum combined taxable income under line (1)(c) ($30), combined taxable income under marginal costing is limited to $28.50. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $28.50. Accordingly, the costs attributable to export sales (other than for direct material, direct labor, and export promotion expenses) are $1.50, *i.e.,* line (1)(c) ($30) minus line (2)(g) ($28.50). Under the combined taxable income method of § 1.994–1 (c)(3), Y will have taxable income attributable to the sales of $14.75, i.e., the sum of 1/2 of combined taxable income (1/2 of $28.50) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the commissions Y receives from X are $22.75, i.e., Y's costs ($8, see line (2)(b)(iii)) plus Y's profit ($14.75).

Example (2). (1) Assume the same facts as in example (1), except that gross receipts from export sales are only $85 and gross receipts from all sales remain at $400. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$85.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's taxable income	5.00	
(iv) Total deductions		65.00
(c) Maximum combined taxable income		20.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):		
(a) Gross receipts from Y's export sales (line (1)(a))		85.00
(b) Multiply by overall profit percentage (as determined in example (1)) (percent)		30%
(c) Overall profit percentage limitation		25.50

Since maximum combined taxable income under line (1)(c) ($20) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is limited to $20. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $20. Accordingly, no costs (other than for direct material, direct labor, and export promotion expenses) will be attributed to export sales. Under the combined taxable income method of § 1.994–1(c)(3), Y will have taxable income attributable to the sales of $10.50, i.e., the sum of 1/2 of combined taxable income (1/2 of $20) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the Commissions Y receives from X are $18.50, *i.e.,* Y's costs ($8, see line (2)(b)(iii) of example (1)) plus Y's profit ($10.50).

(2) If export promotion expenses are not claimed in determining taxable income of Y under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $20.50, computed as follows:

(3) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$85.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Total deductions		60.00

(c) Maximum combined taxable income	25.00
(4) Overall profit percentage limitation (line (2)(c))	25.50

Since maximum combined taxable income under line (3)(c) ($25) is less than the overall profit percentage under line (4) ($25.50), combined taxable income under marginal costing is limited to $25. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $25. Accordingly, no costs (other than for direct material and direct labor) will be attributed to export sales. Under the combined taxable income method of § 1.994-1(c)(3), Y will have taxable income attributable to the sales of $12.50, i.e., 1/2 of combined taxable income (1/2 of $25). Accordingly, the commissions Y receives from X are $20.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example (1)) plus Y's profit ($12.50).

Example (*3*). (1) Assume the same facts as in example (1), except that gross receipts from export sales are only $85, gross receipts from all sales remain at $400, and Y has costs of $40 consisting of Y's export promotion expenses of $35 and costs of $5 other than for direct material, direct labor, or export promotion expenses. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$85.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's taxable income	35.00	
(iv) Total deductions		95.00
(c) Maximum combined taxable income (loss)		(10.00)
(2) Overall profit percentage limitation (as determined in example (2))		25.50

Since maximum combined taxable income under line (1)(c) (which is a loss of $10) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is a loss of $10 and, under the combined taxable income method of § 1.994-1(c)(3), Y will have no taxable income or loss attributable to the sales. Accordingly, the commissions Y receives from X are $40, *i.e.*, Y's costs ($40).

(2) If export promotion expenses are not claimed in determining Y's taxable income under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $52.50 computed as follows:

(3) Maximum combined taxable income (determined under paragraph (b)(2) of this section) (line (3)(c) of example (2))	$25.00
(4) Overall profit percentage limitation (as determined in example (2))	25.50

The results would be the same as in part (2) of example (2), except that the commissions Y receives from X are $52.50, *i.e.*, Y's costs ($40) plus Y's profit ($12.50).

[T.D. 7364, 40 FR 29836, July 16, 1975; 40 FR 33972, Aug. 13, 1975]

§ 1.995–1 Taxation of DISC income to shareholders.

(a) *In general.* (1) Under § 1.991-1(a), a corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for the taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax.

(2) Under section 995(a), the shareholders of a DISC, or a former DISC, are subject to taxation on the earnings and profits of the DISC in accordance with the provisions of chapter 1 of the Code generally applicable to shareholders, but subject to the modifications provided in sections 995, 996, and 997.

(3) Under § 1.996-3, three divisions of earnings and profits of a DISC, or former DISC, are defined: "accumulated DISC income", "previously taxed income", and "other earnings and profits". Under § 1.995-2, certain amounts of the DISC's earnings and profits are deemed to be distributed as dividends to shareholders of the DISC at the close of the DISC's taxable year in which such earnings were derived. Such deemed distributions do not cause a reduction in the DISC's earnings and profits, but are taken into account in § 1.996-3(c) as an increase in previously taxed income. To the extent the DISC's earnings and profits are paid out in a subsequent distribution which is, under § 1.996-1, treated as made out of such "previously taxed income," they will not be taxable to the shareholders a second time.

(4) In general, "accumulated DISC income" is the earnings and profits of the DISC which have not been deemed distributed and which may be deferred from taxation so long as they are not actually distributed with respect to its stock. However, deferral of taxation on "accumulated DISC income" may be terminated, in whole or in part, in the event of: (i) Certain foreign investment attributable to producer's loans (see § 1.995-2(a)(5) and § 1.995-5); (ii) revocation of the election to be treated as a DISC or other disqualification (see § 1.995-3); and (iii) certain dispositions of DISC stock in which gain is realized (see § 1.995-4).

(5) Since a DISC is not taxed on its taxable income, section 246(d) and § 1.246-4 provide that the deduction otherwise allowed under section 243 shall not be allowed with respect to a dividend from a DISC, or former DISC, paid or treated as paid out of accumulated DISC income or previously taxed income or with respect to a deemed distribution in a qualified year under § 1.995-2(a).

(b) *Amounts and character of amounts includible in shareholder's gross income.* Each shareholder of a corporation which is a DISC, or former DISC, shall include in his gross income—

(1) Amounts actually distributed to him that are includible in his gross income in accordance with paragraph (c) of this section.

(2) Amounts which, pursuant to § 1.995-2, he is deemed to receive as a distribution taxable as a dividend on the last day of each of the corporation's taxable years for which it qualifies as a DISC,

(3) Amounts which, pursuant to § 1.995-3, he is deemed to receive as a distribution taxable as a dividend in the event the corporation revokes its election to be treated as a DISC or otherwise is disqualified as a DISC, and

(4) Gain realized on certain dispositions of stock in the corporation which, under § 1.995-4, is includible in his gross income as a dividend.

(c) *Treatment of actual distributions.* (1) Except as provided in subparagraph (3) of this paragraph, amounts actually distributed to a shareholder of a DISC, or former DISC, with respect to his stock are includible in his gross income in accordance with section 301.

(2) Since a deemed distribution does not reduce the earnings and profits of a DISC, it does not affect the determination as to whether a subsequent actual distribution is a "dividend" under section 316(a). Since, however, the amount of a deemed distribution increases "previously taxed income", it does affect the determination as to whether a subsequent actual distribution is excluded (as described in subparagraph (3) of this paragraph) from gross income.

(3) Under § 1.996-1(c), the amount of any actual distribution (including a deficiency distribution made pursuant to § 1.992-3), with respect to stock in a DISC, or former DISC, which is treated under § 1.996-1 as made out of previously taxed income, is excluded by the distributee from gross income, but only to the extent that such amount does not exceed the adjusted basis of the distributee's stock. Under § 1.996-5(b), that portion of any actual distribution which is treated as made out of previously taxed income shall be applied against and reduce the adjusted basis of the stock and, to the extent that it exceeds the adjusted basis of the stock, it shall be treated as gain from the sale or exchange of property.

(4) A deficiency distribution pursuant to § 1.992-3 may be made after the close of the DISC's taxable year with respect to which it is made. The determinations as to whether such deficiency distribution is a dividend under section 301 and as to which division of earnings and profits is the source thereof depend upon the status of the DISC's earnings and profits account and divisions thereof at the time the distribution is actually made. See § 1.996-1(d) for the priority of such deficiency distribution over other actual distributions made during the same taxable year.

(d) *Personal holding company income.* (1) Any amount includible in a shareholder's gross income as a dividend with respect to the stock of a DISC, or former DISC, pursuant to paragraph (b) of this section shall be treated as a dividend for all purposes of the Code, except that for purposes of determining whether such shareholder is a personal holding company within the meaning of section 542 any amount deemed distributed for qualified years under § 1.995-2 or upon disqualification under § 1.995-3, any amount of gain on certain dispositions of DISC stock to which § 1.995-4 applies, and any amount treated under § 1.996-1 as distributed out of accumulated DISC income or previously taxed income shall not be treated as a dividend or any other kind of income described in section 543(a).

(2) Notwithstanding subparagraph (1) of this paragraph, the shareholder may treat as an item of income described under section 543 (for example, rents) any amount to which the exception in such subparagraph (1) applies, if it establishes to the satisfaction of the district director that such amount is attributable to earnings and profits derived from such item of income.

[T.D. 7324, 39 FR 35109, Sept. 30, 1974]

§ 1.995-2 Deemed distributions in qualified years.

(a) *General rule.* Under section 995 (b)(1), each shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to his stock on the last day of each taxable year of the DISC, in an amount which is equal to his pro rata share of the sum (as limited by paragraph (b) of this section), of the following five items:

(1) An amount equal to the gross interest derived by the DISC during such year from producer's loans (as defined in § 1.993-4).

(2) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property (other than property which in the hands of the DISC is a qualified export asset) which was previously transferred to it in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(3) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property which in the hands of the DISC is a qualified export asset (other than stock in trade or property described in section 1221(1)) and which was previously transferred to the DISC in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC and which would have been includible in the transferor's gross income as ordinary income if its entire realized gain had been recognized upon the transfer.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(4) An amount equal to one-half of the excess (if any) of the taxable income of the DISC for such year (computed as provided in § 1.991-1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), and (3) of this paragraph.

(5) The amount of foreign investment attributable to producer's loans of the DISC, as of the close of the "group taxable year" ending with such taxable year of the DISC, determined in accordance with § 1.995-5. The amount of such foreign investment attributable to producer's loans so determined for any taxable year of a former DISC shall be deemed distributed as a dividend to the shareholders of such former DISC on the last day of such taxable year. See § 1.995-3(e) for the effect that such deemed distribution has on scheduled installments of deemed distributions of accumulat-

ed DISC income under § 1.995-3(a) upon disqualification.

(b) *Limitation on amount of deemed distributions under section 995(b)(1).* (1) The sum of the amounts described in paragraph (a) (1) through (4) of this section which is deemed distributed pro rata to the DISC's shareholders a dividend for any taxable year of the corporation shall not exceed the DISC's earnings and profits for such year.

(2) The amount of foreign investment attributable to producer's loans of the DISC (as described in paragraph (a)(5) of this section) which is deemed to be distributed pro rata to the DISC's shareholders as dividends for any taxable year of the corporation shall not exceed the lower of the corporation's accumulated DISC income at the beginning of such year or the corporation's accumulated earnings and profits at the beginning of such year (but not less than zero)—

(i) Increased by any DISC income of the corporation for such year as defined in § 1.996-3(b)(2) (*i.e.*, any excess of the DISC's earnings and profits for such year over the sum of the amounts described in paragraph (a) (1) through (4) of this section), or

(ii) Decreased by any deficit in the corporation's earnings and profits for such year.

Thus, for example, if a DISC has a deficit in accumulated earnings and profits at the beginning of a taxable year of $10,000, current earnings and profits of $12,000, no amounts described in paragraph (a) (1) through (4) of this section for the year, and foreign investment attributable to producer's loans for the taxable year of $5,000, the DISC would have a deemed distribution described in paragraph (a)(5) of this section of $5,000 for the taxable year. On the other hand, suppose the DISC had accumulated earnings and profits of $13,000 at the beginning of the taxable year, accumulated DISC income of $10,000 at the beginning of the taxable year, a deficit in earnings and profits for the taxable year of $12,000, no amounts described in paragraph (a) (1) through (4) of this section for the taxable year, and foreign investment attributable to producer's loans for the taxable year of $5,000. Under these facts the DISC would have no deemed distribution described in paragraph (a)(5) of this section because the corporation had no DISC income for the taxable year and the current year's deficit in earnings and profits subtracted from the DISC's accumulated DISC income at the beginning of the year produces a negative amount. For rules relating to the carryover to a subsequent year of the $5,000 of foreign investment attributable to producer's loans, see § 1.995-5(a)(6).

(3) If, by reason of the limitation in subparagraph (1) of this paragraph, less than the sum of the amounts described in paragraph (a) (1) through (4) of this section is deemed distributed, then the portion of such sum which is deemed distributed shall be attributed first to the amount described in subparagraph (1) of such paragraph, to the extent thereof; second to the amount described in subparagraph (2) of such paragraph, to the extent thereof; third to the amount described in subparagraph (3) of such paragraph, to the extent thereof; and finally to the amount described in subparagraph (4) of such paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1972, X transfers certain property to Y in exchange for Y's stock in a transaction in which X does not recognize gain or loss by reason of the application of section 351(a). Included in the property transferred to Y is depreciable property described in paragraph (a)(3) of this section on which X realizes, but does not recognize by reason of the application of section 1245(b)(3), a gain of $20,000. If X had sold such property for cash, the $20,000 gain would have been recognized as ordinary income under section 1245. Also included in the transfer to Y is 100 shares of stock in a third corporation (which is not a related foreign export corporation) on which X realizes, but does not recognize, a gain of $5,000. In 1973, Y sells such property and recognizes a gain of $25,000 on the depreciable property and $8,000 on the 100 shares of stock. Y has accumulated earnings and profits at the beginning of 1973 of $5,000, earnings and profits for 1973 of $72,000, and taxable income for 1973 of $100,000. At the beginning of 1973, Y has $6,000 of accumulated DISC income, no previously taxed income, and a deficit of $1,000 of other earnings and profits. Under these facts and the additional facts assumed in the table below, X is treated as having received a deemed distribution taxable as a dividend of $76,000 on December 31, 1973, determined as follows:

(1) Gross interest derived by Y in 1973 from producer's loans	$7,000
(2) Amount of gain on depreciable property (lower of Y's recognized gain ($25,000) or X's gain not recognized on section 1245 property ($20,000))	20,000
(3) Amount of gain on stock (lower of X's gain not recognized or Y's recognized gain ($8,000) ($5,000))	5,000
(4) One-half excess of taxable income for 1973 over the sum of lines (1), (2), and (3) (1/2 of ($100,000 minus $32,000))	34,000
(5) Limitation on lines (1) through (4):	
(a) Sum of lines (1) through (4)	66,000
(b) Earnings and profits for 1973	72,000
(c) Lower of lines (a) and (b)	66,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Foreign investment attributable to producer's loans under § 1.995-5	10,000
(b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) and excess of earnings and profits for 1973 over line (5)(c) ($72,000 minus $66,000)	11,000
(c) Lower of lines (a) and (b)	10,000
(7) Total deemed distribution (sum of lines (5)(c) and (6)(c))	76,000

Example (2). Assume the facts are the same as in example (1), except that earnings and profits for 1973 amount to only $60,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend of $65,000 on December 31, 1973, determined as follows:

(5) Limitation on lines (1) through (4):	
(a) Line (5)(a) of example (1)	$66,000
(b) Earnings and profits for 1973	60,000
(c) Lower of lines (a) and (b)	60,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Line (6)(a) of example (1)	10,000
(b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) plus excess of earnings and profits for 1973 over line (5)(c) ($60,000 minus $60,000)	5,000
(c) Lower of lines (a) and (b)	5,000
(7) Total deemed distribution (sum of lines (5)(c) and (6)(c))	65,000

Example (3). Assume the facts are the same as in example (1), except that Y has a deficit in accumulated earnings and profits at the beginning of 1973 of $4,000. Such deficit is comprised of accumulated DISC income of $1,000, no previously taxed income, and a deficit in other earnings and profits of $5,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend in the amount of $72,000 on December 31, 1973, determined as follows:

(5) Limitation on lines (1) through (4):	
(a) Line (5)(a) of example (1)	$66,000
(b) Earnings and profits for 1973	72,000
(c) Lower of lines (a) and (b)	66,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Line (6)(a) of example (1)	10,000
(b) Sum of accumulated earnings and profits at beginning of 1973 (not less than $0), and excess of earnings and profits for 1973 over amount in line (5)(c) ($72,000 minus $66,000)	6,000
(c) Lower of lines (a) and (b)	6,000
(7) Total deemed distribution sum of lines (5)(c) and (6)(c)	72,000

(d) *Special rules for certain tax-free acquisitions of property by the DISC.* (1) For purposes of paragraph (a)(2)(i) and (3)(i) of this section, if—

(i) A DISC acquires property in a first transaction and in a second transaction it disposes of such property in exchange for other property, and

(ii) By reason of the application of section 1031 (relating to like-kind exchanges) or section 1033 (relating to involuntary conversions), the basis in the DISC's hands of the other property acquired in such second transaction is determined in whole or in part with reference to the basis of the property acquired in the first transaction,

then upon a disposition of such other property in a third transaction by the DISC such other property shall be treated as though it had been transferred to the DISC in the first transaction. Thus, if the first transaction is a purchase of the property for cash, then paragraph (a) (2) and (3) of this section will not apply to a sale by the DISC of the other property acquired in the second transaction.

(2) For purposes of paragraph (a) (2)(i) and (3)(i) of this section, if a DISC acquires property in a first transaction and it transfers such prop-

erty to a transferee DISC in a second transaction in which the transferor DISC's gain is not recognized in whole or in part, then such property shall be treated as though it had been transferred to the transferee DISC in the same manner in which it was acquired in the first transaction by the transferor DISC. For example, if X and Y both qualify as DISC's and X transfers property to Y in a second transaction in which gain or loss is not recognized, paragraph (a) (2) or (3) of this section does not apply to a sale of such property by Y in a third transaction if X had acquired the property in a first transaction by a purchase for cash. If, however, X acquired the property from a transferor other than a DISC in the first transaction in which the transferor's realized gain was not recognized, then paragraph (a) (2) or (3) of this section may apply to the sale by Y if the other conditions of such paragraph (a) (2) or (3) are met.

(3) If a DISC acquires property in a second transaction described in subparagraph (1) or (2) of this paragraph in which it (or, in the case of a second transaction described in subparagraph (2) of this paragraph, the transferor DISC) recognizes a portion (but not all) of the realized gain, then the amount described in paragraph (a)(2)(ii) or (a)(3)(ii) of this section with respect to a disposition by the DISC of such acquired property in a third transaction shall not exceed the transferor's gain which was not recognized on the first transaction minus the amount of gain recognized by the DISC (or transferor DISC) on the second transaction.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). X and Y are corporations each of which qualifies as a DISC and uses the calendar year as its taxable year. In 1972, X acquires section 1245 property in a first transaction in which the transferor's entire realized gain of $17 is not recognized. In 1973, X transfers such property to Y in a second transaction in which X realizes a gain of $20 of which only $4 is recognized. (On December 31, 1973, X's shareholders are treated as having received a deemed distribution of a dividend which includes such $4 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Y sells such property and recognizes a gain of $25. With respect to Y's shareholders on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section would be limited to $13, which is the amount of the transferor's gain which was not recognized on the first transaction ($17) minus the amount of gain recognized by X on the second transaction ($4).

Example (2). Z is a DISC using the calendar year as its taxable year. In a first transaction in 1972, in exchange for its stock, Z acquires section 1245 property from A, an individual who is its sole shareholder, in a transaction in which A's realized gain of $30 is not recognized by reason of the application of section 351(a). In a second transaction in 1973, Z exchanges such property for other property in a like-kind exchange to which section 1031(b) applies and recognizes $10 of a realized gain of $35. (On December 31, 1973, A is treated as having received a deemed distribution of a dividend which includes such $10 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Z sells the property acquired in the like-kind exchange and recognizes a gain of $25. With respect to A on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section is limited to $20, which is the amount of A's gain which was not recognized on the first transaction ($30) minus the amount of gain recognized by Z on the second transaction ($10).

(e) *Carry back of net operating loss and capital loss to prior DISC taxable year.* For purposes of sections 991, 995, and 996, the amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover or under section 1212 for a capital loss carryback or carryover shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, the amount of the deduction will be the same whether or not the corporation was a DISC in the year of the loss or in the year to which the loss is carried. For provisions setting forth adjustments to the DISC's, or former DISC's, deemed distributions, adjustments to its divisions of earnings and profits, and other tax consequences arising from such carrybacks, see § 1.996–8.

[T.D. 7324, 39 FR 35110, Sept. 30, 1974]

§ 1.995-3 Distributions upon disqualification.

(a) *General rule.* Under section 995 (b)(2), a shareholder of a corporation which is disqualified from being a DISC, either because pursuant to § 1.992-2(e)(2) it revoked its election to be treated as a DISC or because it has failed to satisfy the requirements as set forth in § 1.992-1 to be a DISC for a taxable year, shall be deemed to have received (at the times specified in paragraph (b) of this section) distributions taxable as dividends aggregating an amount equal to his pro rata share of the accumulated DISC income (as defined in § 1.996-3(b)) of such corporation which was accumulated during the immediately preceding consecutive taxable years for which the corporation was a DISC. The pro rata share referred to in the preceding sentence shall be determined as of the close of the last of such consecutive taxable years for which the corporation was a DISC. See § 1.996-7(c) for rules relating to the carryover of, and maintaining a separate account for, such accumulated DISC income in certain reorganizations.

(b) *Time of receipt of deemed distributions.* Distributions described in paragraph (a) of this section shall be deemed to be received in equal installments on the last day of each of the 10 taxable years of the corporation following the year of the disqualification described in paragraph (a) of this section, except that in no case may the number of equal installments exceed the number of the immediately preceding consecutive taxable years for which the corporation was a DISC.

(c) *Transfer of shares.* Deemed distributions are includible under paragraphs (a) and (b) of this section in a shareholder's gross income as a dividend only so long as he continues to hold the shares with respect to which the distribution is deemed made. Thus, the transferee of such shareholder will include in his gross income under paragraphs (a) and (b) of this section the remaining installments of the deemed distribution which the transferor would have included in his gross income as a dividend had he not transferred the shares. However, if the transferee acquires the shares in a transaction in which the transferor's gain is treated under § 1.995-4 in whole or in part as a dividend, then under § 1.996-4(a) such transferee does not include subsequent installments in his gross income to the extent that the transferee treats such subsequent installments as made out of previously taxed income.

(d) *Effect of requalification.* Deemed distributions under paragraphs (a) and (b) of this section continue and are includible in gross income as dividends by the shareholders whether or not the corporation subsequently requalifies and is treated as a DISC.

(e) *Effect of actual distributions and deemed distributions under section 995(b)(1)(E).* If, during the period a shareholder of a DISC, or former DISC, is taking into account deemed distributions under paragraphs (a) and (b) of this section, an actual distribution is made to him out of accumulated DISC income or a deemed distribution because of foreign investment attributable to producer's loans is made under § 1.995-2(a)(5) out of accumulated DISC income, such actual or deemed distribution shall first reduce the last installment of the deemed distributions scheduled to be included in the shareholder's gross income as a dividend, and then the preceding scheduled installments in reverse order. If deemed distributions are scheduled to be included in gross income for two or more disqualifications, an actual distribution or a deemed distribution under § 1.995-2 (a)(5) which is treated as made out of accumulated DISC income reduces the deemed distributions resulting from the earlier disqualification first.

(f) *Examples.* This section may be illustrated by the following examples:

Example (1). X Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. X qualifies as a DISC for taxable years 1972 through 1975, but, pursuant to § 1.992-2(e)(2), revokes its election as of January 1, 1976, and is disqualified as a DISC. On that date, X has $24,000 of accumulated DISC income. X's shareholders will be deemed to receive $6,000 in distributions taxable as a dividend on the last day of each of X's four succeeding taxable years (1977, 1978, 1979, and 1980).

Example (2). Assume the same facts as in example (1), except that in 1978 X makes an actual distribution of $22,000 to its shareholders of which $10,000 is treated under § 1.996-1 as made out of accumulated DISC income. (The remaining $12,000 of such distribution is treated as made out of previously taxed income.) The actual distribution would first reduce the $6,000 deemed distribution scheduled for 1980 to zero and then reduce the $6,000 deemed distribution scheduled for 1979 to $2,000. Thus, X's shareholders include in 1978 $16,000 is gross income as dividends ($10,000 of actual distributions and the $6,000 deemed distribution scheduled for that year) and $2,000 as a dividend in 1979.

Example (3). Assume the same facts as in example (2), except that X requalifies as a DISC for taxable year 1977 during which it derives $7,000 of DISC income (computed after taking into account a deemed distribution under § 1.995-2(a)(4) of $7,000), but is again disqualified in 1978. In addition X makes an actual distribution in 1977 equal to the deemed distribution of $7,000. Such actual distribution is excluded from gross income under § 1.996-1(c). In 1977. X's shareholders include in gross income as dividends the $6,000 deemed distribution upon disqualification (in addition to the deemed distributions of $7,000 under § 1.995-2 for 1977 when it was treated as a DISC). The actual distribution in 1978 still reduces the installments resulting from the earlier disqualification. Thus, in 1978, X's shareholders include $16,000 in gross income as dividends. In 1979, X's shareholders include $9,000 in gross income as dividends (the final installment of $2,000 from the earlier disqualification plus the single deemed distribution of $7,000 resulting from the later disqualification).

[T.D. 7324, 39 FR 35112, Sept. 30, 1974]

§ 1.995-4 Gain on certain dispositions of stock in a DISC.

(a) *Purpose.* Under section 995(c), if a shareholder disposes of stock in a DISC, or former DISC, in a transaction in which gain is recognized, part or all of such gain is includible in his gross income as a dividend to the extent provided in paragraph (b) of this section. If a shareholder disposes of such stock in a transaction in which gain is not recognized, part or all of such gain otherwise not recognized is, under section 995(c), recognized and includible in his gross income as a dividend to the extent provided in paragraph (c) of this section. The purpose of the provisions of section 995(c) and this section is to insure that accumulated DISC income, the taxation of which is deferred by reason of sections 991 and 995, eventually becomes subject to tax, at ordinary income rates. Therefore, to the extent that an amount of gain on a disposition of DISC stock reflects such deferred accumulated DISC income, such amount is to be treated as a dividend in order to eliminate tax avoidance potential arising from the fact that the basis of such stock will be increased in the hands of the purchaser. In the case of certain transactions in which gain is not recognized, such tax avoidance potential arises not from an increased basis, but rather from the possible absorption by a non-DISC entity of, and therefore disappearance of, special DISC tax attributes (e.g., accumulated DISC income) that insure ultimate taxability at ordinary income rates. Therefore, gain realized in a nontaxable disposition will be treated as a dividend to the extent it reflects accumulated DISC income but only where, as part of the transaction, the DISC tax attributes no longer exist in a corporation qualified as a DISC. For provisions which disallow the deduction under section 243 for dividends under this section, see § 1.246-4.

(b) *Sale or exchange of DISC stock*—(1) *In general.* Under the first sentence of section 995(c), if a shareholder disposes, or is treated as disposing, of stock in a DISC, or former DISC, then any gain recognized on such disposition shall be included in his gross income as a dividend, notwithstanding any other provision of the Code, to the extent of the amount of accumulated DISC income which is attributable to such stock and which was accumulated in taxable years of such corporation during the period or periods such stock was held or treated under paragraph (d) of this section as held by such shareholder. To the extent his recognized gain exceeds such amount of accumulated DISC income, it is taxable as gain from the sale or exchange of the stock.

(2) *Nonapplication of subparagraph (1).* The provisions of subparagraph (1) of this paragraph do not apply (i) to the extent gain is not recognized (such as, for example, in the case of a gift or an exchange of stock to which

section 354 applies) and (ii) to the amount of any recognized gain which is taxable as a dividend (such as, for example, under section 301 or 356(a)(2)) or as gain from the sale or exchange of property which is not a capital asset. The amount taxable as a dividend under section 301 or 356(a)(2) is subject to the rules provided in § 1.995-1(c) for the treatment of actual distributions by a DISC.

(c) *Certain exchanges in which gain is not recognized*—(1) *General.* Under the second sentence of section 995(c), if stock in a corporation which is a DISC, or former DISC, is disposed of in a transaction in which its separate corporate existence as a DISC, or former DISC, is terminated then, notwithstanding any other provision of the Code, any gain realized on such transaction shall be recognized and includible in the transferor's gross income as a dividend, but only to the extent that such gain—

(i) Would not have been recognized but for the provisions of this paragraph, and

(ii) Does not exceed the amount of the accumulated DISC income of such corporation attributable to such stock and which was accumulated in taxable years of such corporation during the period or periods the stock disposed of was held or treated under paragraph (d) of this section as held by the transferor.

(2) *Cessation of separate corporate existence as a DISC, or former DISC.* For purposes of subparagraph (1) of this paragraph, separate corporate existence as a DISC, or former DISC, will be treated as having ceased if, as a result of the transaction, there is no separate entity which is a DISC and to which is carried over the accumulated DISC income and other tax attributes of the DISC, or former DISC, the stock of which is disposed of. Thus, for example, if stock in a DISC, or former DISC, is exchanged in a transaction described in section 381(a) (relating to carryovers in certain corporate acquisitions), the gain realized on the transfer of such stock will not be recognized under subparagraph (1) of this paragraph if the assets of such DISC, or former DISC, are acquired by a corporation which immediately after the acquisition qualifies as a DISC. For a further example, if a DISC, or former DISC, is liquidated in a transaction to which section 332 (relating to complete liquidations of subsidiaries) applies the transaction will be subject to subparagraph (1) of this paragraph if the basis to the transferee corporation of the assets acquired on the liquidation is determined under section 334(b)(2) or if immediately after such liquidation the transferee of such assets does not qualify as a DISC. However, the separate corporate existence as a DISC, or former DISC, will not be treated as having ceased in the case of a mere change in place of organization, however effected. See § 1.996-7 for rules for the carryover of the divisions of a DISC's earnings and profits to one or more DISC's.

(d) *Holding period of stock.* For purposes of this section, the period during which a shareholder has held stock includes the period he is considered to have held it by reason of the application of section 1223 and, if his basis is determined in whole or in part under the provisions of section 1014(d) (relating to special rule for DISC stock acquired from decedent), the holding period of the decedent. Such holding period is to exclude the day of acquisition but include the day of disposition. Thus, for example, if A purchases stock in a DISC on December 31, 1972, and makes a gift of such stock to B on June 30, 1973, then on December 31, 1974, B will be treated as having held the stock for 2 full years. If the basis of the stock in C's hands is determined under section 1014(d) upon a transfer from B's estate on December 31, 1976, by reason of B's death on June 30, 1974, then on December 31, 1976, C will be treated as having held the stock for 4 full years.

(e) *Accumulated DISC income allocable to shareholder under section 995 (c)*—(1) *In general.* Under this paragraph, rules are prescribed for purposes of paragraphs (b) and (c) of this section as to the manner of determining, with respect to the stock of a DISC, or former DISC, disposed of, the amount of accumulated DISC income which is attributable to such stock and which was accumulated in taxable years of the corporation during the period or periods the stock disposed of was held or treated under paragraph (d) of this section as held by the transferor. Subparagraphs (2), (3), and (4) of this paragraph set forth a method of computation which may be employed to determine such amount. Any other method may be employed so long as the result obtained would be the same as the result obtained under such method.

(2) *Step 1.* Determine the increase (or decrease) in accumulated DISC income for each taxable year of the DISC, or former DISC, by subtracting from the amount of accumulated DISC income (as defined in § 1.996-3(b)) at the close of each taxable year the amount thereof as of the close of the immediately preceding taxable year.

(3) *Step 2.* (i) Determine for each taxable year of the DISC, or former DISC, the increase (or decrease) in accumulated DISC income per share by dividing such increase (or decrease) for the year by the number of shares outstanding or deemed outstanding on each day of such year.

(ii) If the number of shares of stock in the corporation outstanding on each day of a taxable year of the DISC, or former DISC, is not constant, then the number of such shares deemed outstanding on each day of such year shall be the sum of the fractional amounts in respect of each share which was outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing the number of days in the taxable year on which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by the total number of days in such taxable year.

(iii) If for any taxable year of a DISC, or former DISC, the share disposed of was not held (or treated under paragraph (d) of this section as held) by the disposing shareholder for the entire year, then the amount of increase (or decrease) in accumulated DISC income attributable to such share for such year is the amount determined as if he held the share until the end of such year multiplied by a fraction the numerator of which is the number of days in the taxable year on which the shareholder held (or under paragraph (d) of this section is treated as having held) such share and the denominator of which is the total number of days in the taxable year.

(4) *Step 3.* Add the amounts computed in step 2 for each taxable year of the DISC, or former DISC, in which the shareholder held such share of stock.

(5) *Examples.* This paragraph may be illustrated by the following examples:

Example (1). X Corporation uses the calendar year as its taxable year and elects to be a DISC for the first time for 1973. On January 1, 1973, X has 20 shares issued and outstanding. A and B each own 10 shares. On July 1, 1976, X issues 10 shares to C. On December 31, 1977, A sells his 10 shares to D and recognizes a gain of $120. Under these facts and other facts assumed in the table below, A includes in his gross income for 1977 a dividend under paragraph (b) of this section of $61.30 and long-term capital gain of $58.70.

Year	(a)—Year end accumulated DISC income	(b)—Increase (decrease) in accumulated DISC income	(c)—Shares outstanding	(d)—Increase (decrease) per share (column (b) divided by column (c))
1973	$80	$80	20	$4.00
1974	50	(30)	20	(1.50)
1975	80	30	20	1.50
1976	100	20	[1] 25	.80
1977	140	40	30	1.33
(1) Total increase in accumulated DISC income for each share disposed of (sum of amounts in column (d))				6.13

Year	(a)—Year end accumulated DISC income	(b)—Increase (decrease) in accumulated DISC income	(c)—Shares outstanding	(d)—Increase (decrease) per share (column (b) divided by column (c))
Multiply by number of shares disposed of				10
(2) Total amount of accumulated DISC income attributable to A's shares disposed of				$61.30
(3) A's gain				120.00
(4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3))				61.30
(5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4))				58.70

[1] Under subparagraph (3)(ii) of this paragraph, the aggregate fractional amounts of the 10 shares issued on July 1, 1976, is 5 shares, i.e., 10 shares, multiplied by (183 days/366 days). Thus, the number of shares deemed outstanding for 1976 is 25 shares, i.e., 20 shares plus 5 shares.

Example (*2*). Assume the same facts as in example (1), except that A sells his 10 shares to D on July 1, 1977. Under subparagraph (3)(iii) of this paragraph, the amount of increase in accumulated DISC income for 1977 which is attributable to each share disposed of is limited to $.67, *i.e.*, $1.33 multiplied by 182 days/365 days. Therefore, the sum of the yearly increases (and decreases) in accumulated DISC income for each share is reduced by $.66 (*i.e.*, $1.33 minus $.67). The total increase in accumulated DISC income for each share disposed of is $5.47 (i.e., $6.13 minus $.66). Under these facts, A would include in his gross income for 1977 a dividend of $54.70 and long-term capital gain of $65.30 determined as follows:

(1) Total increase in accumulated DISC income for each share disposed of	$5.47
Multiplied by number of shares disposed of	10
(2) Total amount of accumulated DISC income attributable of to all shares disposed of	54.70
(3) A's gain	120.00
(4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3))	54.70
(5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4))	65.30

[T.D. 7324, 39 FR 35112, Sept. 30, 1974]

§ 1.995-5 Foreign investment attributable to producer's loans.

(a) *In general*—(1) *Limitation.* Under section 995(d), the amount as of the close of a "group taxable year" (as defined in subparagraph (3) of this paragraph) of foreign investment attributable to producer's loans of a DISC for purposes of section 995(b)(1)(E) shall be the excess (as of the close of such year) of—

(i) The smallest of—

(*a*) The amount of the net increase in foreign assets (as defined in paragraph (b) of this section) by domestic and foreign members of the controlled group which includes the DISC,

(*b*) The amount of the actual foreign investment by the domestic members of such group (as determined under paragraph (c) of this section), or

(*c*) The amount of outstanding producer's loans (as determined under § 1.993-4) by such DISC to members of such controlled group, over

(ii) The amount (determined under § 1.995-2 (a)(5) and (b)(2)) of foreign investment attributable to producer's loans treated under section 995(b)(1)(E) as deemed distributions by the particular DISC taxable as dividends for prior taxable years of that particular DISC.

Thus, for example, if the shareholders of a DISC which uses the calendar year as its taxable year (and which is a member of a controlled group in which all of the members use the calendar year as their taxable year) are treated under section 995(b)(1)(E) as receiving foreign investment attributable to producer's loans of a DISC of $0 in 1972, $10 in 1973, and $30 in 1974, or a total of $40, and if the smallest of the amounts described in subdivision (i) of this subparagraph at the end of 1975 is $90, then the amount of the foreign investment attributable to producer's loans of a DISC at the end of 1975 is $50, *i.e.*, the excess (as of the close of 1975) of the smallest of the amounts described in subdivision (i) of this subparagraph ($90) over the sum of the amounts of foreign investment attributable to producer's loans treated under section 995(b)(1)(E) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC ($40). If the separate corporate existence of the DISC as to which the amount described in subdivision (ii) of this subparagraph relates ceases to exist within the meaning of § 1.995-4(c)(2), then such amount shall no longer be taken into account by the group for any purpose. For inclusion of amounts because of certain corporate acquisitions, see paragraph (d) of this section.

(2) *Controlled group; domestic and foreign member.* For purposes of this section—

(i) The term "controlled group" has the meaning assigned to such term by § 1.993-1(k).

(ii) The term "domestic member" means a domestic corporation which is a member of a controlled group, and the term "foreign member" means a foreign corporation which is a member of a controlled group.

(3) *Group taxable year.* (i) The term "group taxable year" refers collectively to the taxable year of the DISC and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the taxable year of the DISC. Thus, for example, if a corporation has a subsidiary which uses the calendar year as its taxable year and which elects to be treated as a DISC, and if the parent has a taxable year ending on October 31, the "group taxable year" for 1973 would refer to calendar year 1973 for the DISC and to the parent's taxable year ending October 31, 1973.

(ii) In cases in which the DISC makes a return for a short taxable year, that is, for a taxable year consisting of a period of less than 12 months, pursuant to section 443 and the regulations thereunder, or § 1.991-1(b)(3), the following rules shall apply—

(*a*) In the case of a change in the annual accounting period of the DISC resulting in a short taxable year, the "group taxable year" refers collectively to the short taxable year and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the short taxable year.

(*b*) In the case of a DISC which is in existence during only part of what would otherwise be its taxable year, the "group taxable year" refers collectively to the short period during which the DISC was in existence and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the 12-month period ending on the last day of the short period.

(iii) With respect to periods prior to the first taxable year for which a member of the group qualified (or is treated) as a DISC, each group taxable year shall be determined under subdivision (i) of this subparagraph as if such member was in existence, it qualified as a DISC, and its taxable year ended on that date corresponding to the date such member's first taxable year ended after it qualified (or is treated) as a DISC whether or not the corporation which qualifies (or is treated) as a DISC used the same taxable year before it so qualified (or is so treated). Thus, for example, if a corporation which is organized on March 3, 1975, uses the calendar year as its taxable year, and is a member of a controlled group which does not include a DISC, first qualifies (or is treated) as a DISC for calendar year 1975, then the term "group taxable year" with respect to years prior to 1975 refers collectively to such prior calendar years and to the taxable year of each corporation in the group ending with or within such prior calendar years.

(iv) For special rules in the case of a group which includes more than one DISC, see paragraph (g) of this section.

(4) *Amounts determined for prior years.* Unless the 3-year limitation is properly elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investments by domestic members) of this section reflect, as of the close of a group taxable year, amounts for all taxable years of members of the group begin-

ning after December 31, 1971 (and amounts arising after December 31, 1971, or such other date prescribed in paragraph (b)(7) of this section), provided that such amounts relate to such group taxable year and preceding group taxable years. Thus, for example, if all members of a controlled group use the calendar year as the taxable year, and 1980 is the first taxable year for which any member of the group qualifies (or is treated) as a DISC, then, unless the 3-year limitation is elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) and (c) of this section will be taken into account beginning with the dates specified in the preceding sentence. For rules as to carryovers on certain corporate acquisitions and reorganizations, see paragraph (d) of this section.

(5) *Three-year elective limitation.* (i) A DISC may elect to take into account only amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investment by domestic members) of this section for the 3 taxable years of each member immediately preceding its taxable year included in that first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC. For purposes of the preceding sentence, determinations shall be made by reference to the taxable year of the issuer or transferor (as the case may be). If an election is made under this subdivision, the offset for uncommitted transitional funds under paragraph (b)(7) of this section is not allowed. If an election is made under this subdivision, the 3-year limitation applies to amounts described in paragraphs (b)(4) and (c) (1) and (2) of this section.

(ii) An election under subdivision (i) of this subparagraph shall not apply with respect to amounts which must be carried over under paragraph (d) of this section in the case of certain corporate acquisitions and reorganizations.

(iii) An election under subdivision (i) of this subparagraph shall be made by the DISC attaching to its first return, filed under section 6011(e)(2), a statement to the effect that the 3-year limitation is being elected under § 1.995-5(a)(5)(i).

(6) *Cumulative basis.* Pursuant to section 995(d)(5), all determinations of amounts specified in this section are to be made on a cumulative basis from the 1st year (or date) provided for in this section. Thus, each such determination shall take into account a net increase or a net decrease during the year, as the case may be. However, if the 3-year limitation is elected under subparagraph (5) of this paragraph, then only amounts with respect to periods specified in such subparagraph (5) are amounts taken into account for years before a member of the group qualifies (or is treated) as a DISC. The computations described in this section may be made in any way chosen by the DISC (including a corporation being tested as to whether it qualifies as a DISC), provided such method results in the amount prescribed by this section.

(7) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. X Corporation, which uses the calendar year as its taxable year, is a member of a controlled group (within the meaning of subparagraph (2) of this paragraph). X elects to be treated as a DISC beginning with 1972. The amount of foreign investment attributable to X's producer's loans treated under section 995(b)(1)(E) as a distribution taxable as a dividend as of the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on lines (1), (2), (3), and (5) being running balances):

Taxable year of X	1972	1973	1974	1975
(1) Net increase (or decrease) in foreign assets since January 1, 1972, at close of group taxable year	($30)	$10	$100	$150
(2) Actual foreign investment at close of group taxable year	20	60	80	140
(3) Outstanding producer's loans of X (the DISC) as of the close of group taxable year	0	40	90	120
(4) Smallest of lines (1), (2), or (3) (not less than zero)	0	10	80	120

Taxable year of X	1972	1973	1974	1975
(5) Less section 995(b)(1)(E) deemed distributions for prior taxable years (sum of lines (5) and (6) from prior year)	0	0	$10	$80
(6) Section 995(b)(1)(E) deemed distribution as of close of taxable year	0	$10	70	40

(b) *Net increase in foreign assets*—(1) *In general.* (i) The term "net increase in foreign assets" when used in this section means the excess for the controlled group (as of the close of the group taxable year) of (*a*) the investment in foreign assets to be taken into account under subparagraph (2) of this paragraph over (*b*) the aggregate of the five offsets allowed by subparagraphs (3) through (7) of this paragraph.

(ii) No amount described in this paragraph (other than amounts described in subparagraphs (4) and (7) of this paragraph) with respect to a member of the group (or foreign branch of a member) shall be taken into account unless it is attributable to a taxable year of such member beginning after December 31, 1971. For a 3-year elective limitation with respect to the first taxable year for which a member qualifies (or is treated) as a DISC, see paragraph (a)(5) of this section. For manner of determining amounts on a cumulative basis, see paragraph (a)(6) of this section.

(2) *Investments made in foreign assets.* (i) For purposes of subparagraph (1) of this paragraph, there shall be taken into account as investment in foreign assets the aggregate of the amounts expended (within the meaning of subdivision (ii) of this subparagraph) during the period described in subparagraph (1)(ii) of this paragraph by all members of the controlled group which includes the DISC to acquire assets described in section 1231(b) (determined without regard to any holding period therein provided) which are located outside the United States (as defined in § 1.993-7) reduced by the aggregate of the amounts received by all such members of the controlled group from the sale, exchange, or involuntary conversion of such assets described in section 1231(b) which are located outside the United States. For purposes of this section, amounts expended for assets which are qualified export assets (as defined in § 1.993-2) of a DISC (or which would be qualified export assets if owned by a DISC) shall not be taken into account. Thus, for example, if a DISC acquires a qualified export asset located outside the United States, the asset is not to be taken into account for purposes of determining the net increase in foreign assets.

(ii) As used in subdivision (i) of this subparagraph, the term "amounts expended" (or amounts received) means the amount of any money or the fair market value (on the date of acquisition, sale, exchange, or involuntary conversion) of any property (other than money) used to acquire (or received for) the assets described in such subdivision (i).

(iii) For purposes of this subparagraph, an asset (other than an aircraft or vessel) is considered as located outside the United States if it was used predominantly outside the United States during the group taxable year. The determination as to whether such an asset is used predominantly outside the United States during the group taxable year in which it was acquired or sold, exchanged, or involuntarily converted shall be made by applying the rules of § 1.993-3(d) except that an aircraft described in section 48(a)(2)(B)(i) or a vessel described in section 48(a)(2)(B)(iii) shall be considered located in the United States and all other aircraft or vessels shall be considered located outside the United States. Thus, for example, if a member of a controlled group which includes a DISC acquires a vessel which is documented under the laws of a foreign country, the amount expended to acquire that vessel is an amount described in subdivision (i) of this subparagraph.

(iv) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example (1). X Corporation, which uses the calendar year as its taxable year, is a domestic member of a controlled group (within the meaning of paragraph (a)(2) of this section). During 1972, in a transaction to which section 1031 applies, X acquires a warehouse located outside the United States and having a fair market value of $100. As consideration, X transfers $20 in cash and a warehouse located within the United States and having a fair market value of $80. Under these facts, $100 will be taken into account as investment in foreign assets.

Example (2). The facts are the same as in example (1), except that the warehouse transferred by X as consideration is located outside the United States. Under these facts, only $20 will be taken into account as investment in foreign assets because the amount expended for such assets (*i.e.*, $100) is reduced by the fair market value of any property located outside the United States received in exchange for such assets (*i.e.*, $80).

(3) *Depreciation with respect to all foreign assets of a controlled group.* (i) An offset allowed by this subparagraph is the depreciation (determined under subdivision (ii) of this subparagraph) or depletion (determined under subdivision (iii) of this subparagraph) attributable to taxable years of the member beginning after December 31, 1971, with respect to all of the group's foreign assets described in subparagraph (2) of this paragraph including such assets acquired prior to the date provided in such subparagraph (2), and without regard to whether the 3-year election in paragraph (a)(5) of this section is made. Thus, for example, depreciation for a taxable year of a member beginning after December 31, 1971, with respect to an asset described in section 1231(b) which is located outside of the United States and which was acquired during a taxable year of the member beginning before January 1, 1972, is an offset allowed by this subparagraph. For a further example, depreciation with respect to a qualified export asset is not such an offset.

(ii) The depreciation taken into account under subdivision (i) of this subparagraph shall be—

(*a*) In the case of an asset owned by a domestic member, only the amount allowed under section 167(b)(1) (relating to the allowance of the straight-line method of depreciation) and § 1.162-11 (b) (relating to amortization in lieu of depreciation), but not the amount allowed under section 179 (relating to the additional first-year depreciation allowance).

(*b*) In the case of an asset owned by a foreign member, the depreciation and amortization (referred to in (*a*) of this subdivision) allowable for purposes of computing earnings and profits under subparagraph (5)(i) of this paragraph.

(iii) The depletion taken into account under subdivision (i) of this subparagraph shall be limited to cost depletion computed under sections 611 and 612 and the regulations thereunder. Thus, percentage depletion is not to be taken into account in computing the offset under this subparagraph.

(4) *Amount of outstanding stock or debt.* (i) An offset allowed by this subparagraph is the outstanding amount of stock (including treasury stock) or debt obligations of any member of the group issued, sold, or exchanged after December 31, 1971, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group, provided that, in the case of a debt obligation, such obligation is not repaid within 12 months after such issuance, sale, or exchange. Thus, for example, if stock is issued to a member of the group before January 1, 1972, and after December 31, 1971, it is sold to a person who is neither a United States person nor a member of the group, an offset allowed by this subparagraph includes the outstanding amount of such stock. For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(ii) The outstanding amount of stock or debt obligations shall be determined in accordance with the following provisions:

(*a*) The outstanding amount of stock or debt obligations described in subdivision (i) of this subparagraph is equal to the net amount described in (*b*) of this subdivision reduced (but not below zero) by the amount described in (*c*) of this subdivision.

(*b*) The net amount described in this subdivision (*b*) is the excess of (*1*) the aggregate of the amount of money and the fair market value of property (other than money) transferred by persons who are not members of the group and who are not U.S. persons as consideration for such stock and debt obligations over (*2*) fees and commission expenses borne by the issuer or transferror with respect to their issuance, sale, or exchange.

(*c*) The amount described in this subdivision (*c*) is the aggregate amount of money and fair market value of property (other than money) distributed to such persons on distributions in respect of such stock from other than earnings and profits or on distributions in redemption of such stock and the amount of principal paid pursuant to such debt obligations.

(*d*) For purposes of this subdivision (ii), in the case of a redemption, the stock or debt redeemed shall be charged against the earliest of such stock or debt issued, sold, or exchanged in order to determine the amount by which the balance of outstanding stock or debt is to be reduced. For purposes of this subparagraph, the fair market value of property received as consideration shall be determined as of the date the transaction occurs, and a contribution to capital within the meaning of section 118 shall be treated as the issuance of stock.

(iii) The provisions of subdivision (i) of this subparagraph apply regardless of the treatment under the Code of the transaction in which the stock or debt was issued, sold, or exchanged. Thus, for example, if X Corporation, a member of a controlled group which includes a DISC, acquires from a nonresident alien individual in exchange solely for X's voting stock all of the stock of Y Corporation pursuant to a reorganization as defined in section 368(a)(1)(B), the fair market value of the Y stock on the date of the exchange would be an offset allowed by this subparagraph.

(iv) The provisions of this subparagraph may be illustrated by the following example:

Example. X Corporation is a member of a controlled group (within a meaning of paragraph (a)(2) of this section) every member of which uses the calendar year as its taxable year. On January 1, 1972, X issues in a public offering its stock to persons described in subdivision (i) of this subparagraph who, in the aggregate, pay $1,000 as consideration. X pays $100 in underwriting fees. On the same date, X receives $425 upon issuing a $500 debt obligation to such persons at a discount of $75 and pays $25 in underwriting fees. On December 31, 1972, the offset allowed under this subparagraph is $1,300, i.e., ($1,000 minus $100) plus ($425 minus $25). If, during 1973, X makes a distribution of $150 (not in redemption) from other than earnings and profits with respect to such stock, then the offset is reduced to $1,150.

(5) *Earnings and profits.* (i) An offset allowed by this subparagraph is one-half the aggregate of the earnings and profits accumulated for all taxable years beginning after December 31, 1971, computed (without regard to any distributions from earnings and profits by a foreign corporation to a domestic corporation in accordance with § 1.964-1 (relating to a controlled foreign corporation's earnings and profits), of each foreign member of the group which is controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and each foreign branch of a domestic member of the group (computed as if the branch were a foreign corporation). The DISC is bound by any action on behalf of a foreign member that was taken pursuant to § 1.964-1(c)(3) or by any failure to take action by or on behalf of a foreign member within the time specified in § 1.964-1(c)(6). With respect to a foreign member for which action was not previously required under § 1.964-1(c)(6) to be taken, the DISC may take action on behalf of such member by attaching a statement to that effect to the return of the DISC under section 6011(e)(2) for the first taxable year during which it qualifies (or is treated) as a DISC and there is outstanding a producer's loan made by such DISC to a member of the controlled group which includes the DISC.

(ii) If the aggregate of the accumulated earnings and profits described in subdivision (i) of this subparagraph is a deficit, the amount allowable as an offset under this subparagraph is zero.

(6) *Royalties and fees.* An offset allowed by this subparagraph is one-half the royalties and fees paid by foreign members of the group to domestic members of the group and by foreign

branches of domestic members of the group to domestic members of the group during the taxable years of such members beginning after December 31, 1971.

(7) *Uncommitted transitional funds.* (i) An offset allowed by this subparagraph for the uncommitted transitional funds of the group is the sum described in subdivision (ii) of this subparagraph of the amount of certain capital raised under the foreign direct investment program and the amounts described in subdivision (iv) of this subparagraph of certain foreign excess working capital held on October 31, 1971.

(ii) The amount described in this subdivision of certain capital raised under the foreign direct investment program is the excess (if any) of—

(*a*) The amount of the offset allowed by subparagraph (4) of this paragraph, determined, however, with respect to the stock and debt obligations of domestic members of the group outstanding on December 31, 1971 (including amounts treated as stock outstanding by reason of a contribution to capital), whether or not outstanding after such date, which were issued, sold, or exchanged on or after January 1, 1968, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group, but only to the extent the taxpayer establishes that such amount constitutes a long-term borrowing (see 15 CFR § 1000.324) for purposes of the foreign direct investment program (see 15 CFR Part 1000), over

(*b*) The amount (determined under paragraph (c) of this section) of actual foreign investment by the domestic members of the group during the portion of the period such stock or debt obligations have been outstanding prior to January 1, 1972, such determination to be made by substituting January 1, 1968, for the December 31, 1971, date specified in such paragraph (c) and by not taking into account the earnings and profits described in paragraph (c)(3) of this section.

For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(iii) (*a*) A taxpayer may establish that an amount under subdivision (ii) (*a*) of this subparagraph constitutes a long-term borrowing for purposes of the foreign direct investment program by keeping records sufficient to demonstrate that appropriate reports were filed with the Office of Foreign Direct Investment of the Department of Commerce with respect to the foreign borrowing or by any other method satisfactory to the district director.

(*b*) The amounts described in subdivision (ii) (*a*) of this subparagraph include amounts with respect to which an election under section 4912(c), to subject certain obligations of a United States person to the interest equalization tax, has been made, provided that the obligations to which such amounts relate were issued by an "overseas financing subsidiary" described in 15 CFR Part 1000N and were assumed by a United States person from such overseas financing subsidiary. Thus, for example, if an overseas financing subsidiary issues its notes to a foreign person in 1968, and such notes are assumed by its United States parent in 1973, which parent elects under section 4912(c) to have the notes subject to the interest equalization tax, then the amount of money received by the subsidiary is an amount described in subdivision (ii)(*a*) of this subparagraph.

(iv) The amount described in this subdivision of foreign excess working capital is the amount of liquid assets held by the foreign members of such group and foreign branches of domestic members of such group on October 31, 1971 (whether or not so held after such date) in excess of their reasonable working capital needs (as defined in § 1.993-2 (e)) on that date, but only to the extent not included in subdivision (ii) of this subparagraph. For purposes of this subdivision, the term "liquid assets" means money, bank deposits (not including time deposits), and indebtedness of any kind (including time deposits) which on the day acquired had a maturity of 2 years or less.

(8) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. X Corporation, which uses the calendar year as its taxable year is a member of a controlled group (within the meaning of paragraph (a)(2) of this section). X elects to be treated as a DISC beginning with 1972. The amount of net increase in foreign assets of the group at the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on each line being running balances):

Taxable year of X	1972	1973	1974	1975
(1) Investment in foreign assets	$150	$165	$260	$300
(2) Depreciation with respect to foreign assets of group	20	40	60	80
(3) Amount of stock or debt outstanding issued after Dec. 31, 1971	30	30	30	30
(4) One-half earnings and profits of foreign members	40	70	100	130
(5) Royalties and fees paid by foreign members to domestic members	10	15	20	20
(6) Uncommitted transitional funds	10	10	10	10
(7) Sum of lines (2) through (6)	110	165	220	270
(8) Net increase in foreign assets (line (1) minus line (6))	40	0	40	30

(c) *Actual foreign investment by domestic members.* For purposes of determining the limitation in paragraph (a) of this section, the amount of the actual foreign investment by domestic members of a controlled group is the sum (as of the close of the group taxable year) determined on a cumulative basis (see paragraph (a)(6) of this section) of—

(1) *Outstanding stock or debt (including contributions to capital).* The outstanding amount (determined in accordance with the principles of paragraph (b)(4)(ii) of this section, applied with respect to stock or debt obligations described in this subparagraph) of stock (including treasury stock) or debt obligations (other than normal trade indebtedness) of foreign members of the group issued, sold, or exchanged after December 31, 1971, by any person (whether or not a member) which is not a domestic member to domestic members of the group, provided that the outstanding amount of debt obligations of any foreign member shall be the greater of such amount outstanding at the close of the taxable year of such member or the highest such amount outstanding at any time during the immediately preceding 90 days,

(2) *Transfers to foreign branches.* The amount of money or the fair market value of property (other than money) transferred by domestic members of the group after December 31, 1971, to foreign branches of such members in transactions which would, if the branch were a corporation, be in consideration for the sale of stock or debt obligations of (or a contribution of capital to) such foreign branches (as determined under subparagraph (1) of this paragraph), and

(3) *Earnings and profits of foreign members.* One-half of the earnings and profits (computed in accordance with paragraph (b)(5) of this section for purposes of computing net increase in foreign assets) of foreign members of the group which are controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and foreign branches (treated for this purpose as a corporation) of domestic members of the group accumulated during the taxable years of such foreign members (or branches) beginning after December 31, 1971, or, if later, the taxable year referred to in paragraph (a)(5)(i) of this section if the 3-year election provided for in such paragraph (a)(5)(i) is made.

(d) *Carryovers on certain corporate acquisitions and reorganizations*—(1) *Certain corporate acquisitions.* (i) If—

(*a*) A member of a controlled group ("first controlled group") acquires in a transaction to which section 381 applies the assets of a corporation which is a member of a second controlled group or acquires stock in such a corporation pursuant to a reorganization as defined in section 368(a)(1)(B) to which section 361 applies, or

(*b*) A member or combination of members of the first controlled group acquire in a transaction not described in (*a*) of this subdivision a majority interest (as defined in paragraph (e)(2) of this section) in the stock of a corporation which is a member of a second controlled group which includes a DISC so that such DISC after the acquisition is a member of the new controlled group,

then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after such acquisition, all amounts described in paragraphs (a) through (c) of this section, including the amount specified in paragraph (a)(1)(ii) of this section (relating to amounts treated under section 995(b)(1)(E) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC), with respect to members of the second controlled group which become members of the new controlled group shall carry over to such new controlled group. For purposes of this subdivision (i), a controlled group may consist of only one member. With respect to certain transactions involving foreign corporations, see section 367.

(ii) If a member or combination of members of a controlled group, immediately after an acquisition of stock to which subdivision (i) of this subparagraph applies, do not control the total combined voting power (determined under § 1.957-1(b)) of the corporation whose stock was acquired, proper apportionment consistent with the principles of paragraph (e)(5) of this section shall be made with respect to amounts to which paragraphs (a) through (c) of this section apply.

(iii) (*a*) If subdivision (i) of this subparagraph applies, then for purposes of determining the application of the 3-year elective limitation provided for in paragraph (a)(5) of this section, the rules in (*b*), (*c*), and (*d*) of this subdivision (iii) apply.

(*b*) If both the "first controlled group" and the "second controlled group" (as those terms are defined in subdivision (i) of this subparagraph) include a DISC, and a DISC in either group has elected the 3-year limitation provided in paragraph (a)(5) of this section, then only those amounts taken into account under such paragraph (a)(5) by the electing DISC or DISC's shall be taken into account.

(*c*) If one of the groups includes a DISC and the other does not, and if the DISC has elected the 3-year limitation provided in paragraph (a)(5) of this section, then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after the acquisition, all amounts described in paragraphs (a) through (c) of this section with respect to members of the controlled group which did not include the DISC shall carry over to such new controlled group, but only to the extent provided in such paragraph (a)(5), computed as if the group taxable year in which the acquisition occurred was the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(*d*) If (*c*) of this subdivision (iii) applies, except that the DISC has not elected the 3-year limitation provided in paragraph (a)(5) of this section, then the DISC in the new controlled group as constituted after the acquisition may, with respect to members of the controlled group which did not include the DISC, make the election provided in such paragraph (a)(5), and treat the year in which the acquisition occurred as if it were the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(iv) If a majority interest, or an interest in addition to a majority interest, is acquired in a transaction other than a transaction described in subdivision (i) of this subparagraph, then the rules in paragraph (e) of this section (relating to the acquisition of the foreign assets of a corporation) apply.

(2) *Corporation ceasing to be a member.* As of the date a corporation which is a member of a controlled group ceases to be a member of such group, the amounts of such group described in paragraphs (a) through (c) of this section will be reduced by such amounts which are attributable to the corporation which is no longer a member of the group.

(e) *Acquisition of a majority interest in a corporation*—(1) *In general.* If paragraph (d)(1)(i) of this section (relating to certain corporate acquisitions in which all amounts described in paragraphs (a) through (c) of this section carry over) does not apply, then, for purposes of determining under paragraph (b)(2) of this section the investments made in foreign assets by a controlled group, the acquisition of a majority interest (as defined in subparagraph (2) of this paragraph) or an interest in addition to a majority interest in a corporation by any member or combination of members of the controlled group is considered an acquisition of the assets (to the extent provided in subparagraph (5) of this paragraph) of the acquired corporation by the group, including the assets of any foreign corporation in which the acquired corporation owns a majority interest (to the extent provided in subparagraph (5) of this paragraph). For the rules concerning the date upon which an acquisition of a majority interest is considered to have occurred, see subparagraph (3) of this paragraph.

(2) *Majority interest.* For purposes of this section, a majority interest is more than 50 percent of the total combined voting power of all classes of a corporation's stock entitled to vote, as determined under § 1.957-1(b).

(3) *Acquisition date.* For purposes of this paragraph, an acquisition of a majority interest shall be considered to have occurred on the day on which the combined voting power of the group first reached the percentage required in subparagraph (2) of this paragraph.

(4) *Valuation of assets.* For purposes of this section, the amount of a corporation's assets deemed acquired is the fair market value of the assets on the date a majority interest, or an interest in addition to a previously held majority interest, is acquired.

(5) *Apportionment in the case of the acquisition of less than all of the voting stock.* (i) If the acquisition described in subparagraph (1) of this paragraph of a majority interest is of less than 100 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, then for purposes of subparagraph (1) of this paragraph the amount of the foreign assets of the corporation deemed acquired as of the day the majority interest is considered acquired shall be an amount equal to the fair market value of all of the corporation's foreign assets described in paragraph (b)(2) of this section as of such day multiplied by the percentage of the total combined voting power (determined under § 1.957-1(b)) held by members of the group on the day the majority interest is considered acquired.

(ii) If any member or combination of members of the controlled group hold a majority interest in a corporation, then for purposes of subparagraph (1) of this paragraph the acquisition of additional combined voting power by members of the controlled group shall be considered an acquisition of its foreign assets described in paragraph (b)(2) of this section in an amount equal to the fair market value of all such assets held by the foreign corporation on the date of the acquisition, multiplied by the increase (expressed in percentage points) in total combined voting power (as determined under § 1.957-1(b)) which occurred.

(6) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation uses the calendar year as its taxable year. On November 18, 1973, M acquires from A, an individual United States person, for $1 million cash all 10,000 shares of the voting stock of N, a foreign corporation. N's only asset is a warehouse located in France with a fair market value on the date of acquisition of $1 million. Under subparagraph (1) of this paragraph, the controlled group of which M is a member is considered to have expended $1 million for the acquisition of foreign assets described in paragraph (b)(2) of this section.

Example (2). The facts are the same as in example (1), except that on November 18, 1973, M acquires only 80 percent of N's voting stock. M is considered to have expended $800,000 for the acquisition of assets described in paragraph (b)(2) of this section, computed as follows:

(1) Fair market value of N's foreign assets described in paragraph (b)(2) of this section	$1,000,000
(2) Multiply by percentage of total combined voting power of all classes of N stock entitled to vote acquired by M	.8
(3) Amount considered expended	$800,000

Example (3). The facts are the same as in example (2), except that individual A is not a United States person, and M acquires the

80 percent of N voting stock in exchange for cash of $100,000 and M stock having a fair market value on the date of the acquisition of $700,000. M is considered to have acquired assets described in paragraph (b)(2) of this section in the amount of $800,000 (see computations in example (2)) and to have an offset under paragraph (b)(4) of this section (relating to outstanding stock or debt) of $700,000 (the fair market value of the M stock transferred to A who is not a United States person). However, the controlled group of which M is a member is not considered to have acquired any other amounts described in paragraphs (a) through (c) of this section with respect to N for taxable years prior to the taxable year of N during which the acquisition occurred.

Example (4). P Corporation, which uses the calendar year as its taxable year, is a member of a controlled group which includes a DISC. During 1973, P acquires from B, an individual United States person, for cash, 30 percent of the total combined voting power of all classes of stock entitled to vote of Q, a foreign corporation. All of Q's assets are assets described in paragraph (b)(2) of this section. No additional interest in Q is acquired by members of the group during 1973. The controlled group of which Q is a member is not considered to have made any investments in foreign assets described in such paragraph (b)(2) as of the close of 1973.

Example (5). Assume the same facts as in example (4). Assume further that during 1974, R Corporation, a member of the controlled group which includes P, acquires for cash 40 percent of the total combined voting power of all classes of stock of Q entitled to vote as follows: 20 percent on July 31, and 20 percent on December 31. Thus, on December 31, 1974, members of the controlled group own 70 percent of Q's voting power (30+20+20) and on that date are considered to have acquired a majority interest in Q. The fair market value of Q's assets on December 31, 1974, is $5 million. The group is considered to have expended $3,500,000 for the acquisition of assets described in paragraph (b)(2) of this section computed as follows:

(1) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section as of the date the acquisition is deemed to have occurred under subparagraph (3) of this paragraph (December 31, 1974)	$5,000,000
(2) Multiply by percentage of total combined voting power of all classes of Q stock entitled to vote held by members of the group on such date	.7
	$3,500,000

Example (6). The facts are the same as in example (5). Assume further that on July 15, 1975, P acquires the remaining 30 percent of the total combined voting power of all classes of Q stock entitled to vote, and on such date the fair market value of Q's assets is $5,500,000. The group is considered to have expended $5,150,000 for the acquisition of assets described in paragraph (b)(2) of this section as of the close of 1975, computed as follows:

(1) Amount of prior years' investment	$3,500,000
(2) Investment during 1975:	
(a) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section on July 15, 1975	$5,500,000
(b) Multiply by additional percentage acquired of total combined voting power of all classes of Q stock entitled to vote	.3
(c) Investment during 1975	$1,650,000
(3) Amount considered expended for foreign assets described in paragraph (b)(2) of this section by reason of the acquisition of Q stock	$5,150,000

(f) *Records.* A DISC shall keep or be readily able to produce such permanent books of account or records as are sufficient to establish the transactions and amounts described in this section. Where applicable, such books of account or records shall be cumulative and shall show transactions and amounts of the members of the controlled group which includes the DISC which occurred prior to the date the DISC qualified (or is treated) as a DISC.

(g) *Multiple DISC's*—(1) *Allocation among DISC's.* In the case of a controlled group which includes more than one DISC, the amounts described in paragraphs (b) and (c) of this section shall be allocated among the DISC's in order to determine the limitation in paragraph (a) of this section. Each DISC's allocable portion of these amounts shall be equal to the total of such amounts multiplied by a fraction the numerator of which is the individual DISC's outstanding producer's loans to members of the group, and the denominator of which is the aggregate amounts of outstanding producer's loans to members of the group by all DISC's which are members of the group.

(2) *Different taxable years.* If all of the DISC's which are members of the controlled group do not have the same taxable year, then one such DISC

shall on behalf of all such DISC's elect to make all computations under section 995(d) as if all DISC's that are members of the group use the same taxable year as the actual taxable year of any one of the DISC's. The election as to which DISC's taxable year is to be used shall be made by the electing DISC attaching to its first return, filed under section 6011(e)(2), a statement indicating which such taxable year will be used. Once such an election is made it may not be revoked until such time as all of the DISC's which are members of the group use the same taxable year. If this subparagraph applies, books and records must be kept by the group which are adequate to show the necessary computations under section 995(d).

(3) This paragraph may be illustrated by the following example:

Example. Corporation X and corporation Y are members of the same controlled group and each has elected to be treated as a DISC. X uses a taxable year ending March 31, and Y uses a taxable year ending November 30. Notwithstanding the fact that all other members of the group use the calendar year as their taxable year, all computations for purposes of determining the amount of foreign investment attributable to producer's loans under section 995(d) must be made as if both DISC's use a taxable year ending either March 31 (X's taxable year) or November 30 (Y's taxable year).

[T.D. 7324, 39 FR 35114, Sept. 30, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976]

§ 1.996-1 Rules for actual distributions and certain deemed distributions.

(a) *General rule.* Under section 996(a)(1), any actual distribution (other than a distribution described in paragraph (b) of this section or to which § 1.995-4 applies) to a shareholder by a DISC, or former DISC, which is made out of earnings and profits shall be treated as made—

(1) First, out of "previously taxed income" (as defined in § 1.996-3(c)) to the extent thereof,

(2) Second, out of "accumulated DISC income" (as defined in § 1.996-3(b)) to the extent thereof, and

(3) Third, out of "other earnings and profits" (as defined in § 1.996-3(d)) to the extent thereof.

(b) *Special rule for qualifying distributions and deemed distributions under section 995(b)(1)(E).* Under section 996 (a)(2), any actual distribution to meet qualification requirements made pursuant to § 1.992-3, and any deemed distribution pursuant to § 1.995-2(a)(5) (relating to foreign investment attributable to producer's loans), which is made out of earnings and profits shall be treated as made—

(1) First, out of "accumulated DISC income" (as defined in § 1.996-3(b)) to the extent thereof,

(2) Second, out of "other earnings and profits" (as defined in § 1.996-3(d)) to the extent thereof, and

(3) Third, out of "previously taxed income" (as defined in § 1.996-3(c)) to the extent thereof.

(c) *Exclusion from gross income.* Under section 996(a)(3), amounts distributed out of previously taxed income shall be excluded by the distributee from gross income. However, see § 1.996-5(b) for treatment as gain from the sale or exchange of property of the portion of an actual distribution out of previously taxed income to the extent it exceeds the adjusted basis of the stock with respect to which the distribution is made.

(d) *Priority of distributions.* Under section 996(c), for purposes of determining their treatment under paragraphs (a), (b), and (c) of this section, distributions made during a taxable year shall be treated as being made in the following order—

(1) Deemed distributions under §§ 1.995-2 and 1.995-3.

(2) Actual distributions to meet qualification requirements made pursuant to § 1.992-3 in the order in which they are made, and

(3) Other actual distributions in the order in which they are made.

Thus, the treatment of any distribution shall be determined after the divisions of earnings and profits have been properly adjusted by taking into account distributions of higher priority which are made or deemed made during the same taxable year.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Y Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. During 1973, Y makes a cash distribution of $100 to X Corporation, Y's sole shareholder. For 1973, Y has no earnings and profits. As of the beginning of 1973, Y has $300 of accumulated earnings and profits, which consist of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. The entire $100 distribution is a dividend under section 316. However, $40 thereof is treated as made out of previously taxed income and is thus excluded from gross income. Accordingly, only $60 is treated as distributed out of accumulated DISC income and includible in gross income. See § 1.246-4 for the inapplicability of the dividend received deduction with respect to the entire distribution of $100.

Example (2). Assume the same facts as in example (1), except that the cash distribution is designated as a distribution to meet qualification requirements made pursuant to § 1.992-3. Under these facts, X includes the entire distribution in its gross income as a dividend. Of the $100 distributed, $70 is treated as made out of accumulated DISC income and the remaining $30 is treated as made out of other earnings and profits. The dividend received deduction under section 243 is available only with respect to such $30.

[39 FR 35120, Sept. 30, 1974]

§ 1.996-2 Ordering rules for losses.

(a) *In general.* Under section 996(b), if for any taxable year a DISC, or a former DISC, incurs a deficit in earnings and profits, such deficit shall be charged—

(1) First, to other earnings and profits (as defined in § 1.996-3(d)) to the extent thereof,

(2) Second, to accumulated DISC income (as defined in § 1.996-3(b)) to the extent thereof, subject to the special rule in paragraph (b) of this section,

(3) Third, to previously taxed income (as defined in § 1.996-3(c)) to the extent thereof, and

(4) To the extent that the amount of such deficit exceeds the sum of the amounts charged in accordance with subparagraphs (1), (2), and (3) of this paragraph, to other earnings and profits (as defined in § 1.996-3(d)).

Thus, the excess deficit charged to other earnings and profits under subparagraph (4) of this paragraph will create a deficit therein in the amount of such excess. To determine the amount of any division of earnings and profits for the purpose of determining under § 1.996-1 the treatment of any actual and certain deemed distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in § 1.316-2(b) for determining the amount of earnings and profits available on the date of any distribution.

(b) *Deficits subsequent to a disqualification.* A deficit in earnings and profits of a DISC, or former DISC, shall not be charged to accumulated DISC income which has been determined is to be deemed distributed to the shareholders pursuant to § 1.995-3 as a result of a revocation of election or other disqualification. Thus, in accordance with paragraph (a) of this section as modified by this paragraph, a deficit incurred by a former DISC following such a revocation or disqualification shall be charged first to other earnings and profits and then to previously taxed income with any balance being charged to other earnings and profits and creating a deficit therein. The preceding sentence shall also apply in the case of a deficit incurred by a DISC which has no accumulated DISC income accumulated during its current taxable year and all immediately preceding consecutive taxable years for which it was a DISC. If as a result of the application of this paragraph the amount of a deficit in other earnings and profits exceeds the amount of a deficit in accumulated earnings and profits, then upon any subsequent actual distribution the deficit in other earnings and profits shall be reduced by the lower of (1) the amount of such actual distribution chargeable to accumulated DISC income or previously taxed income or (2) the amount of such excess.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). X Corporation, which uses the calendar year as its taxable year, becomes a DISC beginning with 1976. In addition to other facts assumed in the table below, X incurs a deficit in earnings and profits for 1979 of $70. Such deficit is charged to the divisions of X's earnings and profits pursuant to paragraph (a) of this section in the manner set forth in such table.

	Accumulated DISC income	Previously taxed income	Other earnings and profits
Balance Jan. 1, 1976			$50
Increase for 1976	$10	$8	
Increase for 1977	10	8	
Increase for 1978	10	8	
Balance Jan. 1, 1979	30	24	50
Deficit for 1979 of $70:			
Charge No. 1			(50)
Charge No. 2	(20)		
Balance Jan. 1, 1980	10		0

Example (2). Assume the same facts as in example (1), except that effective for taxable years beginning with 1979, X revokes its election to be treated as a DISC. Under § 1.995-3, X has $30 of accumulated DISC income which is to be deemed distributed $10 per year in 1980, 1981, and 1982. The deficit in earnings and profits for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

	Accumulated DISC income	Previously taxed income	Other earnings and profits
Balance Jan. 1, 1979	$30	$24	$50
Deficit for 1979 of $70:			
Charge No. 1			(50)
Charge No. 2		(20)	
Balance Jan. 1, 1980	30	4	0

Example (3). Assume the same facts as in example (2), except that the deficit in earnings and profits for 1979 is $120. Assume further that for 1980, 1981, and 1982, during which years X's shareholders are receiving scheduled installments of the deemed distributions of accumulated DISC income under § 1.995-3, X, a former DISC, has neither earnings and profits nor a deficit in earnings and profits. The $120 deficit for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

	Accumulated DISC income	Previously taxed income	Other earnings and profits	Accumulated earnings and profits
Balance Jan. 1, 1979	$30	$24	$50	$104
Deficit for 1979 of $120				(120)
Charge No. 1			(50)	
Charge No. 2		(24)		
Charge No. 3			(46)	
Balance Jan. 1, 1980	30	0	(46)	(16)
Deemed distributions in 1980 under § 1.995-3	(10)	10		
Balance Jan. 1, 1981	20	10	(46)	(16)

Example (4). Assume the same facts as in example (3), except that on December 31, 1980, X makes an actual distribution of $10 out of previously taxed income. On January 1, 1981, X has $20 of accumulated DISC income, no previously taxed income, and a deficit of $36 in other earnings and profits. The deficit of $16 in accumulated earnings and profits remains the same.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974]

§ 1.996-3 Divisions of earnings and profits.

(a) *In general.* For purposes of sections 991 through 997, the earnings and profits of a DISC, or former DISC, shall be treated as composed of the following three divisions:

(1) Accumulated DISC income (as defined in paragraph (b) of this section),

(2) Previously taxed income (as defined in paragraph (c) of this section), and

(3) Other earnings and profits (as defined in paragraph (d) of this section),

(b) *Accumulated DISC income defined.* (1) Accumulated DISC income is that portion of a corporation's earnings and profits which were derived during taxable years for which it qualified as a DISC and which were deferred from taxation. Accumulated DISC income as of the close of each taxable year of the corporation is—

(i) The amount of accumulated DISC income as of the close of the immediately preceding taxable year increased by

(ii) The amount of DISC income for the year (as determined in subparagraph (2) of this paragraph) and reduced (but not below zero) by

(iii) The items enumerated in subparagraph (3) of this paragraph.

(2) Under section 996(f)(1), DISC income is (i) the earnings and profits derived by the corporation during a taxable year for which such corporation is a DISC minus (ii) amounts deemed distributed under § 1.995-2 other than the amount of foreign investment attributable to producer's loans described in § 1.995-2(a)(5). For example, the earnings and profits of a DISC for a taxable year include any amounts includible in such DISC's gross income pursuant to section 951(a) (relating to controlled foreign corporations). Deemed distributions under § 1.995-2(a)(5) are taken into account under subparagraph (3) of this paragraph as a reduction in computing accumulated DISC income.

(3) The accumulated DISC income (as increased by DISC income for the year determined under subparagraph (2) of this paragraph) is reduced by each of the following items in the following order:

(i) Any amount deemed distributed for such year under § 1.995-3 (relating to deemed distributions upon disqualification),

(ii) Any amount of foreign investment attributable to producer's loans deemed distributed for such year under § 1.995-2(a)(5) to the extent it is charged to accumulated DISC income under § 1.996-1(b)(1),

(iii) The amount of any adjustment to accumulated DISC income for such year under § 1.966-4(b)(1), and

(iv) To the extent they are treated, under § 1.996-1 (a) or (b) (relating to ordering rules for distributions), as made out of accumulated DISC income, the amounts of any actual qualifying distributions pursuant to § 1.992-3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to each actual distribution, accumulated DISC income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under § 1.996-2(a)(2) to accumulated DISC income.

(4) Every distribution or other reduction in accumulated DISC income pursuant to subparagraph (3) of this paragraph shall be charged to the most recently accumulated DISC income.

(c) *Previously taxed income.* Under section 996(f)(2), previously taxed income as of the close of each taxable year of the corporation is an amount equal to—

(1) The sum of—

(i) The amount of previously taxed income as of the close of the immediately preceding taxable year,

(ii) Amounts deemed distributed for the current year under § 1.995-2 (relating to deemed distributions in qualified years),

(iii) Amounts deemed distributed for the current year under § 1.995-3 (relating to deemed distributions upon disqualification),

(iv) With respect to a distribution in redemption to which § 1.996-4(b)(1) applies, an amount equal to the excess (if any) of (*a*) the amount of the reduction under § 1.996-4(b)(1) in accumulated DISC income over (*b*) the reduction in the corporation's earnings and profits (see section 312(e)), and

(v) Any amount by which accumulated DISC income is reduced under paragraph (b)(3)(ii) of this section by reason of a deemed distribution as a dividend, under § 1.995-2(a)(5), of an amount of foreign investment attributable to producer's loans,

(2) Decreased (but not below zero), to the extent they are treated, under § 1.996-1 (a) or (b) (relating to ordering rules for distributions), as made out of previously taxed income, by the amounts of any actual qualifying distributions pursuant to § 1.992-3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, previously taxed income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under § 1.996-2(a)(3) to previously taxed income.

(d) *Other earnings and profits.* Under section 996(f)(3), other earnings and profits consist of earnings and profits other than accumulated DISC income and previously taxed income described respectively in paragraphs (b) and (c) of this section. Other earnings and profits as of the close of each taxable year of the corporation is (subject to paragraph (e) of this section) an amount equal to the amount of other earnings and profits as of the close of the immediately preceding taxable year decreased (if necessary, below zero) in the following order by—

(1) To the extent they are treated, under § 1.995-1 (a) or (b) (relating to ordering rules for distributions), as made out of other earnings and profits, the amounts of any actual qualifying distributions pursuant to § 1.992-3 in the order in which they are made, and thereafter the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, other earnings and profits shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under § 1.996-2(a)(1) to other earnings and profits, and

(2) With respect to a distribution in redemption to which § 1.996-4(b)(1) applies, an amount equal to the excess (if any) of (*a*) the reduction in the corporation's earnings and profits (see section 312(e)) over (*b*) the amount of the reduction under § 1.996-4(b)(1) in accumulated DISC income.

(e) *Distributions in kind.* (1) For purposes of determining, under paragraphs (b), (c), and (d) of this section, the amount by which any division of earnings and profits is reduced by reason of a distribution of property (other than money or the DISC's, or former DISC's, own obligations), the amount of such distribution is the fair market value of such property at the time of the distribution.

(2) For any taxable year in which the DISC makes a distribution of such property, the amount of other earnings and profits determined under paragraph (d) of this section (without regard to this subparagraph) shall be—

(i) Increased by the excess (if any) of the amount of such distribution treated as a dividend under section 316(a) over the adjusted basis of such property, and

(ii) Decreased by the excess (if any) of the adjusted basis of such property over the amount of such distribution treated as a dividend under section 316 (a).

Each item of property shall be considered separately for purposes of making the adjustment under this subparagraph.

(f) *Examples.* The provisions of §§ 1.996-1, 1.996-2, and this section may be illustrated by the following examples:

Example (1). M Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. During 1975, M derives no earnings and profits and makes no deemed or actual distributions, except that on December 31, 1975, M's shareholders are treated as having received a dividend distribution of $100 under § 1.995-2 (a)(5) (relating to foreign investment attributable to producer's loans). M's earnings and profits are adjusted as shown on line (2) of the table below on the basis of facts assumed therein.

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance Jan. 1, 1975	$450	$100	$250	$100
(2) Adjustments (see paragraphs (b)(3)(ii) and (c)(1)(v) of this section)	0	(100)	100	0
(3) Balance Jan. 1, 1976	450	0	350	100

Example (2). N Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. During 1973, N derives no earnings and profits for the year and makes no deemed or actual distributions, except that A, a shareholder, realized $200 of gain upon receiving an actual cash distribution of $300 in redemption of N stock having an adjusted basis of $100 in his hands. The redemption is treated as an exchange under section 302(a) but, under section 995(c), A includes the $200 of gain in his gross income as a dividend. Assuming that, under section 312(e), $240 is properly chargeable to capital account of N and that, under § 1.996-4(b), accumulated DISC income is reduced by $200, N's accounts are adjusted on line (2) of the table below on the basis of facts assumed therein.

	Capital	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance Jan. 1, 1973	$2,000	$400	$300	$100	0
(2) Adjustments (see § 1.996-4(b) and paragraph (c)(1)(iv) of this section)	(240)	(60)	(200)	140	0
(3) Balance Jan. 1, 1974	1,760	340	100	240	0

Example (3). P Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1973. During 1974, P derives no earnings and profits for the year and makes no deemed or actual distributions, except for a distribution to B, its sole shareholder, of property with a fair market value of $100 and an adjusted basis in P's hands of $40. Under § 1.996-1(a)(1), B treats the entire amount of the distribution as being made out of previously taxed income and, under § 1.996-1(c), excludes it from his gross income. P's earnings and profits, divisions are adjusted on lines (2) and (3) of the table below on the basis of facts assumed therein.

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance Jan. 1, 1974	$200	$80	$120	0
(2) Adjustment under paragraphs (c)(2) and (e)(1) this section	(40)	0	(100)	0
(3) Adjustment under paragraph (e)(2)(i) of this section	0	0	0	$60
(4) Balance Jan. 1, 1975	160	80	20	60

Example (4). Q Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. On January 1, 1975, Q has accumulated earnings and profits of $1,200 and, during 1975, Q incurs a deficit in earnings and profits of $365. The amount of such deficit incurred as of any date before the close of 1975 cannot be shown. On July 1, 1975, Q makes a cash distribution of $650, with respect to its stock to C, Q's sole shareholder. C subsequently transfers by gift all of his Q stock to D. On December 31, 1975, Q makes a cash distribution of $650, with respect to its stock, to D. Under these facts and additional facts assumed in the table below, C is treated as having received a dividend of $650 of which $320 is treated as distributed out of previously taxed income and excluded from gross income. D is treated as receiving a dividend of $186. Adjustments to Q's earnings and profits accounts are illustrated in the table below:

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance Jan. 1, 1975	$1,200	$800	$320	$80
(2) Portion of 1975 deficit of $365 chargeable as of June 30, 1975, pursuant to § 1.996-2(a)	(181)	(101)	0	(80)
(3) Balance July 1, 1975	1,019	699	320	0
(4) $650 distributed to C on July 1, 1975	(650)	(330)	(320)	0
(5) Portion of 1975 deficit of $365 chargeable as of Dec. 30, 1975, pursuant to § 1.996-2(a)	(183)	(183)	0	0
(6) Balance Dec. 31, 1975	186	186	0	0
(7) $650 distributed to D on Dec. 31, 1975 [1]	(186)	(186)	0	0
(8) Balance Jan. 1, 1976	0	0	0	0

[1] $60 treated as return of capital pursuant to section 301(c)(2).

Examples (5)—(1) *Facts.* R Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. X Corporation is its sole shareholder. At the beginning of 1974, R has a deficit in earnings and profits of $60 all of which is composed of "other earnings and profits". For 1974, R has earnings and profits of $80 before reduction for any distributions and taxable income of $70. On June 15, 1974, R makes a cash distribution to X of $60, with respect to its stock, to which section 301 applies. On August 15, 1974, R makes a cash distribution to X of $30 designated as a distribution to meet qualification requirements pursuant to § 1.992-3. Under § 1.995-2(a), X is deemed to receive, on December 31, 1974, a distribution of a dividend of $35, i.e., one-half of R's taxable income of $70. The tax consequences of these facts to X and their effect on R's earnings and profits are set forth in the subsequent subparagraphs of this example.

(2) *Dividend treatment of actual distributions.* Since R had $80 of earnings and profits for 1974 and a deficit in accumulated earnings and profits at the beginning of 1974, only $80 of the actual distributions ($90) are treated as dividends under sections 301(c)(1) and 316(a)(2). ($10 of the actual distribution, which is not treated as a dividend is treated in the manner specified in section 301(c) (2) and (3).) Thus, under § 1.316-2(b), $26.67 of the actual qualifying distribution made on August 15, 1974 ($30 × $80/$90), and $53.33 of the actual distribution made on June 15, 1974 ($60 × $80/$90), are considered made out of earnings and profits.

(3) *Priority of distributions.* Under § 1.996-1(d), for purposes of adjusting the divisions of R's earnings and profits and determining the treatment of subsequent distributions, the sequence in which each distribution is treated as having been made is—

(i) First, the deemed distribution of $35,

(ii) Second, the actual qualifying distribution of $30 made on August 15, 1974, pursuant to § 1.992-3, and

(iii) Finally, the actual distribution of $60 made on June 15, 1974.

(4) *Treatment and effect of deemed distribution.* Under § 1.995-2(a), on December 31, 1974, X includes the deemed distribution of $35 in its gross income as a dividend. Under paragraph (c)(1)(ii) of this section, R's previously taxed income is increased by $35 as shown on line (3) of the table in subparagraph (7) of this example. Under paragraph (b)(1)(ii) and (2) of this section, accumulated DISC income is increased by $45 of DISC income i.e., R's earnings and profits for 1974, $80, minus the deemed distribution of $35, as shown on line (4) of the table.

(5) *Treatment and effect of actual qualifying distribution of $30.* As indicated in subparagraph (2) of this example, $26.67 of the $30 qualifying distribution on August 15, 1974, is treated as made out of earnings and profits for 1974. Under § 1.996-1(b)(1), the entire $26.67 is treated as distributed out of accumulated DISC income. Thus, on August 15, 1974, X includes $26.67 in its gross income as a dividend. No deduction is allowable under section 243. Under paragraph (b)(3)(iv) of this section, R's accumulated DISC income is reduced by $26.67 as shown on line (6) of the table in subparagraph (7) of this example.

(6) *Treatment and effect of actual distribution of $60.* As indicated in subparagraph (2) of this example, $53.33 of the $60 distribution on June 15, 1974, is treated as made out of earnings and profits for 1974. Under § 1.996-1(a), the $53.33 is treated as distributed out of previously taxed income to the extent thereof, $35, and then out of accumulated DISC income, $18.33. Thus, on June 15, 1974, X includes $18.33 in its gross income as a dividend. Under § 1.996-1(c), the distribution of $35 out of previously taxed income is excluded from gross income. No deduction is allowable under section 243 with respect to the actual distribution of $53.33. Under paragraph (b)(3)(iv) of this section, accumulated DISC income is reduced by $18.33 and, under paragraph (c)(2) of this section, previously taxed income is reduced by $35, as shown on line (7) of the table in subparagraph (7) of this example.

(7) *Summary.* The effects on earnings and profits and the divisions of earnings and profits are summarized in the following table:

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance Jan. 1, 1974		($60.00)			($60.00)
(2) Earnings and profits for year before reduction for distributions	$80.00				
(3) Deemed distribution of $35 to X on Dec. 31, 1974, under § 1.995-2(a)				$35.00	
(4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35))			$45.00		
(5) Balance before actual distributions	80.00	(60.00)	45.00	35.00	(60.00)

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(6) Qualifying distribution of $30 to X on Aug. 15, 1974, pursuant to § 1.992-3	($26.67)		($26.67)		
(7) Actual distribution to P of $60 on June 15, 1974	(53.33)		(18.33)	($35.00)	
(8) Balance Jan. 1, 1975	0	(60.00)	0		($60.00)

Example (6). Assume the facts are the same as in example (5), except that at the beginning of 1974 R's accumulated earnings and profits amount to $60 consisting of accumulated DISC income of $20, previously taxed income of $10, and other earnings and profits of $30. In addition, on August 1, 1974, X transfers all R's stock to Y Corporation in a reorganization described in section 368(a)(1)(B) in which under section 354 X recognizes no gain or loss. Under these facts, X includes in its gross income for 1974 a dividend of $15 which is attributable to the actual distribution of $60 paid out of earnings and profits on June 15, 1974. X excludes from gross income the balance of the $60 distribution ($45) paid out of earnings and profits because, under § 1.996-1(a), it is treated as paid out of previously taxed income. Y includes in its gross income for 1974 a dividend of $65 of which $35 is attributable to the deemed distribution of a dividend to Y on December 31, 1974, under § 1.995-2(a) and $30 is attributable to the qualifying distribution paid out of earnings and profits to Y on August 15, 1974. The adjustments to R's earnings and profits are summarized in the following table:

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance Jan. 1, 1974		$60	$20	$10	$30
(2) Earnings and profits for year before reduction for distributions	$80				
(3) Deemed distribution of $35 to Y on Dec. 31, 1974, under § 1.995-2(a)				35	
(4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35))			45		
(5) Balance before actual distributions	80	60	65	45	30
(6) Qualifying distribution of $30 to Y on Aug. 15, 1974, pursuant to § 1.992-3	(26.67)	(3.33)	(30)		
(7) Actual distribution to X of $60 on June 15, 1974	(53.33)	(6.67)	(15)	(45)	
(8) Balance Jan. 1, 1975		50	20	0	30

[T.D. 7324, 39 FR 35121, Sept. 30, 1974]

§ 1.996-4 Subsequent effect of previous disposition of DISC stock.

(a) *Shareholder adjustment for previously taxed income.* (1) Under section 996(d)(1), except as provided in subparagraph (2) of this paragraph, if—

(i) Gain with respect to a share of stock of a DISC, or former DISC, is treated under § 1.995-4 as a dividend, and

(ii) With respect to such share, any person subsequently receives an actual distribution made out of accumulated DISC income, or a deemed distribution made, pursuant to § 1.995-3, by reason of disqualification, out of accumulated DISC income,

then such person shall treat such distribution in the same manner as a distribution from previously taxed income (and thus excludable from gross income under § 1.996-1(c)) to the extent that the gain referred to in subdivision (i) of this subparagraph exceeds the aggregate amount of any other distributions with respect to such share which were treated under this subparagraph as made from previously taxed income.

(2) In applying subparagraph (1) of this paragraph with respect to a share

of stock in a DISC, or former DISC, the gain referred to in subparagraph (1)(i) of this paragraph does not include any gain to a shareholder on a redemption of such share which qualifies as an exchange under section 302(a) or any gain on a disposition of such share prior to such redemption. Distributions described in subparagraph (1)(ii) of this paragraph do not include a distribution in a redemption which qualifies as an exchange under section 302(a). For adjustments to accumulated DISC income by reason of dividend treatment under § 1.995-4 with respect to gain upon a redemption of DISC stock to which section 302(a) applies and upon a prior disposition of such stock, see paragraph (b) of this section.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. In 1974, under § 1.995-4, A, a shareholder of a DISC, on the sale of his DISC stock to B, is required to treat $20 of his gain as a dividend. The DISC has no previously taxed income and $40 of accumulated DISC income. Subsequently in the same year, B, the purchaser of the stock, receives an actual dividend distribution of $15 with respect to such stock which, under § 1.996-1(a), is treated as made out of accumulated DISC income. The amounts of the DISC's previously taxed income and accumulated DISC income were not adjusted by reason of the $20 treated as a dividend on the prior sale. However, even though the DISC had no previously taxed income, the purchaser would treat the $15 as though it had been paid out of previously taxed income and, therefore would not include the $15 in gross income. If in 1975, B receives another actual distribution of $9 with respect to such stock, $5 (*i.e.*, $20 dividend on A's sale less the $15 distribution to B in 1974 which was treated under subparagraph (1) of this paragraph as made from previously taxed income) is treated as made from previously taxed income and excluded from gross income. The result would be the same if, on January 1, 1975, B had transferred such stock to C by gift and the $9 distribution had been made to C.

(b) *Corporate adjustment upon redemption.* (1) Under section 996(d)(2), if by reason of § 1.995-4 gain on a redemption of stock in a DISC, or former DISC, is included in the shareholder's gross income as a dividend, then the accumulated DISC income shall be reduced by an amount equal to the sum of—

(i) The amount of gain on such redemption which, under § 1.995-4, is treated as a dividend, and

(ii) The amount of any gain with respect to such redeemed stock which, under § 1.995-4, was treated as a dividend on a disposition prior to such redemption minus the amount of distributions with respect to such stock which have been treated as made out of previously taxed income by reason of the application of paragraph (a)(1) of this section.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). The entire stock of a DISC, which uses the calendar year as its taxable year, has been owned equally by A, B, C, and D since it was organized. At the close of 1976, when the DISC has $100 of accumulated DISC income, it redeems all of A's shares in a transaction qualifying as an exchange under section 302(a) and A, under § 1.995-4, includes $25 in his gross income as a dividend. The redemption has the effect of reducing accumulated DISC income by $25 to $75.

Example (2). Assume the same facts as in example (1) except that the stock of the DISC has not been held equally by A, B, C, and D since its organization. A purchased his shares from X in 1974 in a transaction in which X, under § 1.995-4, included in his gross income $30 as a dividend. In 1975, A receives a distribution of $10 out of accumulated DISC income which, under paragraph (a)(1) of this section, is treated as made out of previously taxed income. Under these facts, the redemption of A's stock in 1976 has the effect of reducing accumulated DISC income by $45 to $55 determined as follows:

(a) Accumulated DISC income		$100
(b) Minus sum of:		
(1) Dividend on redemption of A's stock	$25	
(2) Excess of dividend on X's sale ($30) over distribution to A treated as made out of previously taxed income ($10)	$20	
Total		45
(c) Accumulated DISC income on 12/31/76		55

[T.D. 7324, 39 FR 35121, Sept. 30, 1974]

§ 1.996-5 Adjustment to basis.

(a) *Addition to basis.* Under section 996(e)(1) amounts representing deemed distributions as provided in section 995(b) shall increase the basis of the stock with respect to which the distribution is made.

(b) *Reductions of basis.* Under section 996(e)(2), the portion of an actual distribution treated as made out of previously taxed income shall reduce the basis of the stock with respect to which it is made and, to the extent that it exceeds the adjusted basis of such stock, shall be treated as gain from the sale or exchange of property. In the case of stock includible in the gross estate of a decedent for which an election is made under section 2032 (relating to alternate valuation), this paragraph shall not apply to any distribution made after the date of the decendent's death and before the alternate valuation date provided by section 2032. See section 1014(d) for a special rule for determining the basis of stock in a DISC, or former DISC, acquired from a decedent.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

§ 1.996-6 Effectively connected income.

In the case of a shareholder who is a nonresident alien individual or a foreign corporation, trust, or estate, amounts taxable as dividends by reason of the application of § 1.995-4 (relating to gain on disposition of stock in a DISC), amounts treated under § 1.996-1 as distributed out of accumulated DISC income, and amounts deemed distributed under § 1.995-2(a) (1) through (4) shall be treated as gains and distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and shall be subject to tax in accordance with the provisions of section 871(b) and the regulations thereunder in the case of nonresident alien individuals, trusts, or estates, or section 882 and the regulations thereunder in the case of foreign corporations. In no case, however shall other income of such shareholder be taxable as effectively connected with the conduct of a trade or business through a permanent establishment in the United States solely because of the application of this section.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

§ 1.996-7 Carryover of DISC tax attributes.

(a) *In general.* Carryover of a DISC's divisions of earnings and profits to acquiring corporations in nontaxable transactions shall be subject to rules generally applicable to other corporate tax attributes. For example, a DISC which acquires the assets of another DISC in a transaction to which section 381(a) applies shall succeed to, and take into account, the divisions of the earnings and profits of the transferor DISC in accordance with section 381(c)(2).

(b) *Allocation of divisions of earnings and profits in corporate separations.* (1) If one DISC transfers part of its assets to a controlled DISC in a transaction to which section 368(a)(1)(D) applies and immediately thereafter the stock of the controlled DISC is distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then—

(i) The earnings and profits of the distributing DISC immediately before the transaction shall be allocated between the distributing DISC and the controlled DISC in accordance with the provisions of § 1.312-10.

(ii) Each of the divisions of such earnings and profits, namely previously taxed income, accumulated DISC income, and other earnings and profits, shall be allocated between the distributing DISC and the controlled DISC on the same basis as the earnings and profits are allocated.

(iii) Any assets of the distributing DISC whose status as qualified export assets is limited by its accumulated DISC income (e.g., producer's loans described in § 1.993-4, Export-Import Bank and other obligations described in § 1.993-2(h), and financing obligations described in § 1.993-2(i)) shall be treated as having been allocated, for the purpose of determining the classification of such assets in the hands of the distributing DISC or the controlled DISC, on the same basis as the earnings and profits are allocated regardless of how such assets are actually allocated.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. On January 1, 1974, P Corporation transfers part of its assets to S Corporation, a newly organized subsidiary of P, in a transaction described in section 368(a)(1)(D) and distributes all the S stock in a transaction which qualifies under section 355. Immediately before such transfer, P had earnings and profits of $120,000 of which $100,000 constitutes accumulated DISC income. The unpaid balance of P's producer's loans is $80,000 all of which is retained by P. Pursuant to § 1.312-10, 25 percent of P's accumulated DISC income is allocated to S (*i.e.*, $25,000). P's producer's loans will be treated as allocated to S in the same proportion. Accordingly, for purposes of determining, under § 1.993-4(a)(3), the amount of producer's loans which S is entitled to make, S is treated as having an unpaid balance of producer's loans of $20,000 (*i.e.*, 25% × $80,000) and P is treated as having an unpaid balance of $60,000 (*i.e.*, 75% × $80,000).

(c) *Accumulated DISC income accounts of separate DISC's maintained after corporate combination.* If two or more DISC's combine to form a new DISC, or if the assets of one DISC are acquired by another DISC, in a transaction described in section 381(a), accumulated DISC income of the acquired DISC or DISC's shall carry over and be taken into account by the acquiring or new DISC, except that a separate account shall be maintained for the accumulated DISC income of any DISC scheduled to be received as a deemed distribution by its shareholders under § 1.995-3 (relating to deemed distributions upon disqualification). If, as a part of such transaction, the stock of the DISC which has accumulated DISC income scheduled to be deemed distributed is exchanged for stock of the acquiring or new DISC to which such accumulated DISC income is carried over and which maintains a separate account, then such accumulated DISC income shall be deemed distributed pro rata to shareholders of the acquiring or new DISC on the basis of stock ownership immediately after the exchange.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

§ 1.996-8 Effect of carryback of capital loss or net operating loss to prior DISC taxable year.

(a) Under § 1.995-2(e), the deduction under section 172 for a net operating loss carryback or under section 1212 for a capital loss carryback is determined as if the DISC were a domestic corporation which had not elected to be treated as a DISC. A carryback of a net operating loss or of a capital loss of any corporation which reduces its taxable income for a preceding taxable year for which it qualified as a DISC will have the consequences enumerated in paragraphs (b) through (e) of this section.

(b) For such preceding taxable year, the amount of a deemed distribution of one-half of certain taxable income described in § 1.995-2(a)(4) will ordinarily be reduced in effect (but not below zero) by one-half of the sum of the amount of the deduction under section 172 for such year for net operating loss carrybacks and the amount of the deduction under section 1212 for such year for capital loss carrybacks.

(c) The amount of reduction in the deemed distribution under paragraph (b) of this section will have the effect of increasing the limitation, provided in § 1.995-2(b)(2), on the amount of foreign investment attributable to producer's loans which is deemed distributed under § 1.995-2(a)(5).

(d) If the amount of a deemed distribution for a preceding taxable year is reduced as described in paragraph (b) of this section, then for such preceding taxable year the previously taxed income (as defined in § 1.996-3(c)) shall be decreased by the amount of such reduction and the accumulated DISC income (as defined in § 1.996-3(b)) shall be increased by the amount of such reduction. Such adjustments shall be made as of the time the deemed distribution for such preceding taxable year is treated as having occurred. See § 1.996-1(d) for the priority of such deemed distribution in relation to other distributions made in that preceding taxable year.

(e) The amount and treatment of any actual distribution made in such preceding taxable year or a year subsequent to such preceding year, and the treatment of gain on a disposition (in any such year) of the DISC's stock to which § 1.995-4 applies, shall be properly adjusted to reflect the adjustments to previously taxed income and accumulated DISC income described in paragraph (d) of this section.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

§ 1.997-1 Special rules for subchapter C of the Code.

(a) For purposes of applying the provisions of sections 301 through 395 of the Code, any distribution in property to a corporation by a DISC, or former DISC, which is made out of previously taxed income or accumulated DISC income shall be treated as a distribution in the same amount as if such distribution of property were made to an individual, and have a basis, in the hands of the recipient corporation, equal to such amount treated as having been distributed.

(b) This section may be illustrated by the following example:

Example. X Corporation is the sole shareholder of Y Corporation which is a DISC. Y makes an actual distribution of property to X with respect to X's stock in Y. The property has a basis of $50 and a fair market value of $100. The distribution is treated as made out of accumulated DISC income under section 996(a) and is taxable as a dividend under section 301(c)(1). Even though X is a corporation, the amount of the distribution is $100 notwithstanding the provisions of section 301(b)(1)(B) and the basis the property in X's hands is $100 notwithstanding the provisions of section 301(d)(2).

[T.D. 7324, 39 FR 35125, Sept. 30 1974]

GAIN OR LOSS ON DISPOSITION OF PROPERTY

DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

§ 1.1001-1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust).

(b) *Real estate taxes as amounts received.* (1) Section 1001(b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164(d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001(b), any amount received as reimbursement for taxes which are treated under section 164(d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164(d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the seller. See also paragraph (b) of § 1.1012-1.

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164(d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). Assume that the contract price on the sale of a parcel of real estate is $50,000 and that real property taxes thereon in the amount of $1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that $750 of the taxes are treated under section 164(d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is $50,000. Similarly, $50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of $50,000, the amount realized by the seller would be $49,250, since the sales price would be deemed to include $750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, $49,250 would be the purchaser's cost.

Example (2). Assume that the purchaser in example (1), above, paid all of the real property taxes. Assume further that $250 of the taxes are treated under section 164(d) as imposed upon the seller. The amount realized by the seller is $50,250. Similarly, $50,250 is the purchaser's cost, regardless of the taxable year in which the purchaser makes actual payment of the taxes.

Example (3). Assume that the seller described in the first part of example (1), above, paid the real property taxes of $1,000 in the taxable year prior to the taxable year of sale and elected under section 266 to capitalize the $1,000 of taxes. In such a case, the amount realized is $50,750. Moreover, regardless of whether the seller elected to capitalize the real property taxes, the purchaser in that case could elect under section 266 to capitalize the $750 of taxes treated under section 164(d) as imposed upon him, in which case his adjusted basis would be $50,750 (cost of $50,000 plus capitalized taxes of $570).

(c) *Other rules.* (1) Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds such basis. Except as otherwise provided in section 301(c)(3)(B) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 61 as "income from whatever source derived". On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A, an individual on a calendar year basis, purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1954, A's adjusted basis for the stock had been reduced to $1,000 by reason of receipts and distributions described in sections 1016(a)(1) and 1016(a)(4). He received in 1954 a further distribution of $5,000, being a distribution covered by section 1016(a)(4), other than a distribution out of increase of value of property accrued prior to March 1, 1913. This distribution applied against the adjusted basis as required by section 1016(a)(4) exceeds that basis by $4,000. The $4,000 excess is a gain realized by A in 1954 and is includible in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 1016. If A sells the stock in 1955 for $5,000, he realizes in 1955 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(d) *Installment sales.* In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 453.

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011-2.

(2) *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

Example (1). A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $60,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example (2). A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example (3). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example (4). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

(f) *Sale or other disposition of a term interest in property*—(1) *General rule.* Except as otherwise provided in subparagraph (3) of this paragraph, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in subparagraph (2) of this paragraph) a taxpayer shall not take into account that portion of the adjusted basis of such interest which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest (i) is determined pursuant to section 1014 or 1015 and (ii) is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See subparagraph (2) of this paragraph for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies. That portion of the adjusted uniform basis of the entire property which is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest which is not a portion of the adjusted uniform basis of the entire property.

(2) *Term interest defined.* For purposes of section 1001(e) and this paragraph, a "term interest in property" means—

(i) A life interest in property,

(ii) An interest in property for a term of years, or

(iii) An income interest in a trust.

Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A "term interest in property" also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception.* Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014-5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations.* For examples illustrating the application of this paragraph, see paragraph (c) of § 1.1014-5.

(g) *Certain exchanges involving original issue discount.* In the case of certain obligations or investment units exchanged for property, involving original issue discount under the provisions of section 1232(b), the amount realized will be determined in accordance with the rules of paragraph (b)(2)(iii)(b) of § 1.1232-3.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7142, 36 FR 18950, Sept. 24, 1971; T.D. 7207, 37 FR 20797, Oct. 5, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972]

§ 1.1001-2 Discharge of liabilities.

(a) *Inclusion in amount realized*—(1) *In general.* Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(2) *Discharge of indebtedness.* The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61-12(b)(1).

(3) *Liability incurred on acquisition.* In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

(4) *Special rules.* For purposes of this section—

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) *Effect of fair market value of security.* The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

(c) *Examples.* The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

Example (1). In 1976 A purchases an asset for $10,000. A pays the seller $1,000 in cash and signs a note payable to the seller for $9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of $3,100. During this same time period A reduces the outstanding principal on the note to $7,600. At the beginning of 1978 A sells the asset. The buyer pays A $1,600 in cash and assumes personal liability for the $7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is $9,200 ($1,600 + $7,600). Since A's adjusted basis in the asset is $6,900 ($10,000 − $3,100) A realizes a gain of $2,300 ($9,200 − $6,900).

Example (2). Assume the same facts as in example (1) except that A is not personally liable on the $9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is $9,200 and A's gain realized is $2,300 on the sale.

Example (3). In 1975 L becomes a limited partner in partnership GL. L contributes $10,000 in cash to GL and L's distributive share of partnership income and loss is 10 percent. L is not entitled to receive any guaranteed payments. In 1978 M purchases L's entire interest in partnership GL. At the time of the sale L's adjusted basis in the partnership interest is $20,000. At that time L's proportionate share of liabilities, of which no partner has assumed personal liability, is $15,000. M pays $10,000 in cash for L's interest in the partnership. Under section 752(d) and this section, L's share of partnership liabilities, $15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is $25,000 ($10,000 + $15,000). L's gain realized on the sale is $5,000 ($25,000 − $20,000).

Example (4). In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is $9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the $9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) $3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the $9,000 of liabilities is treated by B as money received, thereby making B's amount realized $9,000. B's gain realized is $6,000 ($9,000 − $3,000).

Example (5). In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust". However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 – $1,200).

Example (6). In 1977 D purchases an asset for $7,500. D pays the seller $1,500 in cash and signs a note payable to the seller for $6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling $4,200 thereby reducing D's basis in the asset to $3,300 ($7,500 – $4,200). In 1979 D transfers the asset to a trust which is not a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D $750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to $4,700. D's amount realized on the transfer is $5,450 ($4,700 + $750). Since D's adjusted basis is $3,300, D's gain realized is $2,150 ($5,450 – $3,300).

Example (7). In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is $20,000 consisting of $1,000 cash and a $19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is $15,000 and the remaining principal balance on the note is $19,000. At that time E's adjusted basis in the herd is $16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is $19,000 notwithstanding the fact that the fair market value of the herd was less than $19,000. E's realized gain is $2,500 ($19,000 – $16,500).

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 – $6,000).

[T.D. 7741, 45 FR 81744, Dec. 12, 1980]

§ 1.1002-1 Sales or exchanges.

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise.

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

BASIS RULES OF GENERAL APPLICATION

§ 1.1011-1 Adjusted basis.

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the Code, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue laws.

§ 1.1011-2 Bargain sale to a charitable organization.

(a) *In general.* (1) If for the taxable year a charitable contributions deduction is allowable under section 170 by reason of a sale or exchange of property, the taxpayer's adjusted basis of such property for purposes of determining gain from such sale or exchange must be computed as provided in section 1011(b) and paragraph (b) of this section. If after applying the provisions of section 170 for the taxable year, including the percentage limitations of section 170(b), no deduction is allowable under that section by reason of the sale or exchange of the property, section 1011(b) does not apply and the adjusted basis of the property is not required to be apportioned pursuant to paragraph (b) of this section. In such case the entire adjusted basis of the property is to be taken into account in determining gain from the sale or exchange, as provided in § 1.1001-1(e). In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year for such purposes, that section is to be applied without regard to this section and the amount by which the contributed portion of the property must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange.

(2) If in the taxable year there is a sale or exchange of property which gives rise to a charitable contribution which is carried over under section 170(b)(1)(D)(ii) or section 170(d) to a subsequent taxable year or is postponed under section 170(a)(3) to a subsequent taxable year, section 1011(b) and paragraph (b) of this section must be applied for purposes of apportioning the adjusted basis of the property for the year of the sale or exchange, whether or not such contribution is allowable as a deduction under section 170 in such subsequent year.

(3) If property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which section 1011(b) and this section apply, even though the transferee does not agree to assume or pay the indebtedness.

(4)(i) Section 1011(b) and this section apply where property is sold or exchanged in return for an obligation to pay an annuity and a charitable contributions deduction is allowable under section 170 by reason of such sale or exchange.

(ii) If in such case the annuity received in exchange for the property is nonassignable, or is assignable but only to the charitable organization to which the property is sold or exchanged, and if the transferor is the only annuitant or the transferor and a designated survivor annuitant or annuitants are the only annuitants, any gain on such exchange is to be reported as provided in example (8) in paragraph (c) of this section. In determining the period over which gain may be reported as provided in such example, the life expectancy of the survivor annuitant may not be taken into account. The fact that the transferor may retain the right to revoke the survivor's annuity or relinquish his own right to the annuity will not be considered, for purposes of this subdivision, to make the annuity assignable to someone other than the charitable organization. Gain on an exchange of the type described in this subdivision pursuant to an agreement which is entered into after December 19, 1969, and before May 3, 1971, may be reported as provided in example (8) in paragraph (c) of this section, even though the annuity is assignable.

(iii) In the case of an annuity to which subdivision (ii) of this subparagraph applies, the gain unreported by the transferor with respect to annuity payments not yet due when the following events occur is not required to be included in gross income of any person where—

(*a*) The transferor dies before the entire amount of gain has been reported and there is no surviving annuitant, or

(*b*) The transferor relinquishes the annuity to the charitable organization.

If the transferor dies before the entire amount of gain on a two-life annuity has been reported, the unreported gain is required to be reported by the surviving annuitant or annuitants with respect to the annuity payments received by them.

(b) *Apportionment of adjusted basis.* For purposes of determining gain on a sale or exchange to which this paragraph applies, the adjusted basis of the property which is sold or exchanged shall be that portion of the adjusted basis of the entire property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. The amount of such gain which shall be treated as ordinary income (or long-term capital gain) shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange as the amount realized on the sale or exchange bears to the fair market value of the entire property at such time. The terms "ordinary income" and "long-term capital gain", as used in this section, have the same meaning as they have in paragraph (a) of § 1.170A-4. For determining the portion of the adjusted basis, ordinary income, and long- term capital gain allocated to the contributed portion of the property for purposes of applying section 170(e)(1) and paragraph (a) of § 1.170A-4 to the contributed portion of the property, and for determining the donee's basis in such contributed portion, see paragraph (c) (2) and (4) of § 1.170A-4. For determining the holding period of such contributed portion, see section 1223(2) and the regulations thereunder.

(c) *Illustrations.* The application of this section may be illustrated by the following examples, which are supplemented by other examples in paragraph (d) of § 1.170A-4:

Example (*1*). In 1970, A, a calendar-year individual taxpayer, sells to a church for $4,000 stock held for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. Thus, A makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). Without regard to this section, A is allowed a deduction under section 170 of $6,000 for his charitable contribution to the church, since there is no reduction under section 170(e)(1) with respect to the long-term capital gain. Accordingly, under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis ×$4,000 amount realized/$10,000 value of property). A has recognized long-term capital gain of $2,400 ($4,000 amount realized −$1,600 adjusted basis) on the bargain sale.

Example (*2*). The facts are the same as in example (1) except that A also makes a charitable contribution in 1970 of $50,000 cash to the church. By reason of section

170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church; however, the $6,000 contribution of property is carried over to 1971 under section 170(d). Under paragraphs (a)(2) and (b) of this section the adjusted basis for determining gain for 1970 on the bargain sale in that year is $1,600 ($4,000×$4,000/$10,000). A has a recognized long-term capital gain for 1970 of $2,400 ($4,000−$1,600) on the sale.

Example (3). In 1970, C, a calendar-year individual taxpayer, makes a charitable contribution of $50,000 cash to a church. In addition, he sells for $4,000 to a private foundation not described in section 170(b)(1)(E) stock held for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution of $6,000 of such property to the private foundation ($10,000 value −$4,000 amount realized). C's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000, and during that year he makes no other charitable contributions. By reason of section 170(b)(1)(A), the deduction allowed under section 170 for 1970 is $50,000 for the amount of cash contributed to the church. Under section 170(e)(1)(B)(ii), applied without regard to section 1011(b), the $6,000 contribution of stock is reduced to $3,000 ($6,000 −[50%×($10,000 value of stock −$4,000 adjusted basis)]). However, by reason of section 170(b)(1)(B)(ii), applied without regard to section 1011(b), no deduction is allowed under section 170 for 1970 or any other year for the reduced contribution of $3,000 to the private foundation. Accordingly, paragraph (b) of this section does not apply for purposes of apportioning the adjusted basis of the stock sold to the private foundation, and under § 1.1001-1(e) the recognized gain on the bargain sale is $0 ($4,000 amount realized −$4,000 adjusted basis).

Example (4). In 1970, B, a calendar-year individual taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. B's contribution base for 1970, as defined in section 170(b)(1)(F), is $20,000 and during such year B makes no other charitable contributions. Thus, he makes a charitable contribution to the church of $8,000 ($10,000 value −$2,000 amount realized). Since without regard to this section B is allowed a deduction under section 170 of $2,000 ($8,000 −[$10,000 value −$4,000 adjusted basis]) for his charitable contribution of $8,000 to the church, under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $800 ($4,000 adjusted basis ×$2,000 amount realized/$10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $1,200 ($2,000 amount realized −$800 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of § 1.170A-4, B is allowed a charitable contributions deduction for 1970 of $3,200 ($8,000 value of gift −[$8,000 −($4,000 adjusted basis of property ×$8,000 value of gift/$10,000 value of property)]).

Example (5). The facts are the same as in Example (4) except that B sells the property to the church for $4,000. Thus, B makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). Since without regard to this section B is allowed a deduction under section 170 for 1970 of $0 ($6,000 −[$10,000 value −$4,000 adjusted basis]) under section 170, paragraph (b) of this section does not apply for purposes of apportioning the adjusted basis of the property, and under § 1.1001-1(e) the recognized gain on the bargain sale is $0 ($4,000 amount realized −$4,000 adjusted basis).

Example (6). The facts are the same as in Example (4) except that B sells the property to the church for $6,000. Thus, B makes a charitable contribution to the church of $4,000 ($10,000 value −$6,000 amount realized). Since without regard to this section B is allowed a deduction under section 170 for 1970 of $0 ($4,000 gift −[$10,000 value of property −$4,000 adjusted basis]), paragraph (b) of this section does not apply for purposes of apportioning the adjusted basis of the property, and under § 1.1001-1(e) the recognized short-term capital gain on the bargain sale is $2,000 ($6,000 amount realized −$4,000 adjusted basis).

Example (7). In 1970, C, a calendar-year individual taxpayer, sells to a church for $4,000 tangible personal property used in his business for more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. Thus, C makes a charitable contribution to the church of $6,000 ($10,000 value −$4,000 amount realized). C's contribution base for 1970, as defined in section 170(b)(1)(F), is $100,000 and during such year he makes no other charitable contributions. If C had sold the property at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 value −$4,000 adjusted basis) would have been treated as ordinary income. Thus, there would have been long-term capital gain of $2,000. It is also assumed that the church does not put the property to an unrelated use, as defined in paragraph (b)(3) of § 1.170A-4. Since without regard to this section C is allowed a deduction under section 170 of $2,000 ($6,000 gift −$4,000 ordinary income), under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $1,600 ($4,000 adjusted basis ×$4,000 amount realized/$10,000 value of property).

Accordingly, C has a recognized gain of $2,400 ($4,000 amount realized −$1,600 adjusted basis) on the bargain sale, consisting of ordinary income of $1,600 ($4,000 ordinary income ×$4,000 amount realized/$10,000 value of property) and of long-term capital gain of $800 ($2,000 long-term gain ×$4,000 amount realized/$10,000 value of property). After applying section 1011(b) and paragraphs (a) and (c)(2)(i) of § 1.170A-4, C is allowed a charitable contributions deduction for 1970 of $3,600 ($6,000 gift −[$4,000 ordinary income ×$6,000 value of gift/$10,000 value of property]).

Example (8). (a) On January 1, 1970, A, a male of age 65, transfers capital assets consisting of securities held for more than 6 months to a church in exchange for a promise by the church to pay A a nonassignable annuity of $5,000 per year for life. The annuity is payable monthly with the first payment to be made on February 1, 1970. A's contribution base for 1970, as defined in section 170(b)(1)(F), is $200,000, and during that year he makes no other charitable contributions. On the date of transfer the securities have a fair market value of $100,000 and an adjusted basis to A of $20,000.

(b) The present value of the right of a male age 65 to receive a life annuity of $5,000 per annum, payable in equal installments at the end of each monthly period, is $59,755 ($5,000×[11.469+0.482]), determined in accordance with section 101(b) of the Code, paragraph (e)(1)(iii)(*b*)(*2*) of § 1.101-2, and section 3 of Rev. Rul. 62-216, C.B. 1962-2, 30. Thus, A makes a charitable contribution to the church of $40,245 ($100,000−$59,755). Without regard to this section, A is allowed a deduction under section 170 of $40,245 for his charitable contribution to the church, since the property contributed is not section 170(e) capital gain property within the meaning of paragraph (b)(3) of § 1.170A-4 and no reduction of the contribution is made under section 170(e)(1).

(c) Under paragraph (b) of this section, the adjusted basis for determining gain on the bargain sale is $11,951 ($20,000×$59,755/$100,000). Accordingly, A has a recognized long-term capital gain of $47,804 ($59,755−$11,951) on the bargain sale. Such gain is to be reported by A ratably over the period of years measured by the expected return multiple under the contract, but only from that portion of the annual payments which is a return of his investment in the contract under section 72 of the Code. For such purposes, the investment in the contract is $59,755, that is, the present value of the annuity.

(d) The computation and application of the exclusion ratio, the gain, and the ordinary annuity income are as follows, determined by using the expected return multiple of 15.0 applicable under Table I of § 1.72-9:

A's expected return (annual payments of $5,000×15)	$75,000.00
Exclusion ratio ($59,755 investment in contract divided by expected return of $75,000)	79.7%
Annual exclusion (annual payments of $5,000×79.7%)	$3,985.00
Ordinary annuity income ($5,000−$3,985)	$1,015.00
Long-term capital gain per year ($47,804/15) with respect to the annual exclusion	$3,186.93

(e) The exclusion ratio of 79.7 percent applies throughout the life of the contract. During the first 15 years of the annuity, A is required to report ordinary income of $1,015 and long-term capital gain of $3,186.93 with respect to the annuity payments he receives. After the total long-term capital gain of $47,804 has been reported by A, he is required to report only ordinary income of $1,015.00 per annum with respect to the annuity payments he receives.

(d) *Effective date.* This section applies only to sales and exchanges made after December 19, 1969.

(e) *Cross reference.* For rules relating to the treatment of liabilities on the sale or other disposition or encumbered property, see § 1.1001-2.

[T.D. 7207, 37 FR 20798, Oct. 5, 1972, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.1012-1 Basis of property.

(a) *General rule.* In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property. This general rule is subject to exceptions stated in subchapter O (relating to gain or loss on the disposition of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses), chapter 1 of the Code.

(b) *Real estate taxes as part of cost.* In computing the cost of real property, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. This rule applies whether or not the contract of sale calls for the purchaser to reimburse the seller for such real estate taxes paid or to be paid by the seller. On the other hand, where the purchaser pays (or assumes liability for) real estate taxes which are treated under section 164(d) as imposed upon the seller, such taxes shall be considered part of the cost of the property. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, real estate taxes allocable to the seller under section 164(d). For illustrations of the application of this paragraph, see paragraph (b) of § 1.1001-1.

(c) *Sale of stock*—(1) *In general.* If shares of stock in a corporation are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock and in order to determine the holding period of such stock for purposes of subchapter P, chapter 1 of the Code. If, on the other hand, the lot from which the stock is sold or transferred can be adequately identified, the rule stated in the preceding sentence is not applicable. As to what constitutes "adequate identification", see subparagraphs (2), (3), and (4) of this paragraph.

(2) *Identification of stock.* An adequate identification is made if it is shown that certificates representing shares of stock from a lot which was purchased or acquired on a certain date or for a certain price were delivered to the taxpayer's transferee. Except as otherwise provided in subparagraph (3) or (4) of this paragraph, such stock certificates delivered to the transferee constitute the stock sold or transferred by the taxpayer. Thus, unless the requirements of subparagraph (3) or (4) of this paragraph are met, the stock sold or transferred is charged to the lot to which the certificates delivered to the transferee belong, whether or not the taxpayer intends, or instructs his broker or other agent, to sell or transfer stock from a lot purchased or acquired on a different date or for a different price.

(3) *Identification on confirmation document.* (i) Where the stock is left in the custody of a broker or other agent, an adequate identification is made if—

(*a*) At the time of the sale or transfer, the taxpayer specifies to such broker or other agent having custody of the stock the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or other agent.

Stock identified pursuant to this subdivision is the stock sold or transferred by the taxpayer, even though stock certificates from a different lot are delivered to the taxpayer's transferee.

(ii) Where a single stock certificate represents stock from different lots, where such certificate is held by the taxpayer rather than his broker or other agent, and where the taxpayer sells a part of the stock represented by such certificate through a broker or other agent, an adequate identification is made if—

(*a*) At the time of the delivery of the certificate to the broker or other agent, the taxpayer specifies to such broker or other agent the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or agent.

Where part of the stock represented by a single certificate is sold or transferred directly by the taxpayer to the purchaser or transferee instead of through a broker or other agent, an adequate identification is made if the taxpayer maintains a written record of the particular stock which he intended to sell or transfer.

(4) *Stock held by a trustee, executor, or administrator.* Where stock is held by a trustee or by an executor or administrator of an estate (and not left in the custody of a broker or other agent), an adequate identification is made if at the time of a sale, transfer, or distribution, the trustee, executor, or administrator—

(i) Specifies in writing in the books and records of the trust or estate the particular stock to be sold, transferred, or distributed, and

(ii) In the case of a distribution, also furnishes the distributee with a written document setting forth the particular stock distributed to him.

Stock identified pursuant to this subparagraph is the stock sold, transferred, or distributed by the trust or estate, even though stock certificates from a different lot are delivered to the purchaser, transferee, or distributee.

(5) *Subsequent sales.* If stock identified under subparagraph (3) or (4) of this paragraph as belonging to a particular lot is sold, transferred, or distributed, the stock so identified shall be deemed to have been sold, transferred, or distributed, and such sale, transfer, or distribution will be taken into consideration in identifying the taxpayer's remaining stock for purposes of subsequent sales, transfers, or distributions.

(6) *Bonds.* The provisions of subparagraphs (1) through (5) of this paragraph shall apply to the sale or transfer of bonds after July 13, 1965.

(7) *Book-entry securities.* (i) In applying the provisions of subparagraph (3)(i)(*a*) of this paragraph in the case of a sale or transfer of a book-entry security (as defined in subdivision (iii) (*a*) of this subparagraph) which is made after December 31, 1970, pursuant to a written instruction by the taxpayer, a specification by the taxpayer of the unique lot number which he has assigned to the lot which contains the securities being sold or transferred shall constitute specification as required by such subparagraph. The specification of the lot number shall be made either—

(*a*) In such written instruction, or

(*b*) In the case of a taxpayer in whose name the book entry by the Reserve Bank is made, in a list of lot numbers with respect to all book-entry securities on the books of the Reserve Bank sold or transferred on that date by the taxpayer, provided such list is mailed to or received by the Reserve Bank on or before the Reserve Bank's next business day.

This subdivision shall apply only if the taxpayer assigns lot numbers in numerical sequence to successive purchases of securities of the same loan title (series) and maturity date, except that securities of the same loan title (series) and maturity date which are purchased at the same price on the same date may be included within the same lot.

(ii) In applying the provisions of subparagraph (3)(i)(*b*) of this paragraph in the case of a sale or transfer of a book-entry security which is made pursuant to a written instruction by the taxpayer, a confirmation as required by such subparagraph shall be deemed made by—

(*a*) In the case of a sale or transfer made after December 31, 1970, the furnishing to the taxpayer of a written advice of transaction, by the Reserve Bank or the person through whom the taxpayer sells or transfers the securities, which specifies the amount and description of the securities sold or transferred and the date of the transaction, or

(*b*) In the case of a sale or transfer made before January 1, 1971, the furnishing of a serially-numbered advice of transaction by a Reserve Bank.

(iii) For purposes of this subparagraph:

(*a*) The term "book-entry security" means—

(*1*) In the case of a sale or transfer made after December 31, 1970, a transferable Treasury bond, note, certificate of indebtedness, or bill issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), as amended, or other security of the United States (as defined in (*b*) of this subdivision (iii)) in the form of an entry made as prescribed in 31 CFR Part 306, or other comparable Federal regulations, on the records of a Reserve Bank, or

(*2*) In the case of a sale or transfer made before January 1, 1971, a transferable Treasury bond, note, certificate of indebtedness, or bill issued under the Second Liberty Bond Act, as amended, in the form of an entry made as prescribed in 31 CFR Part 306, Subpart O, on the records of a Reserve Bank which is deposited in an account with a Reserve Bank (*i*) as collateral pledged to a Reserve Bank (in its individual capacity) for advances by it, (*ii*) as collateral pledged to the

United States under Treasury Department Circular No. 92 or 176, both as revised and amended, (*iii*) by a member bank of the Federal Reserve System for its sole account for safekeeping by a Reserve Bank in its individual capacity, (*iv*) in lieu of a surety or sureties upon the bond required by section 61 of the Bankruptcy Act, as amended (11 U.S.C. 101), of a banking institution designated by a judge of one of the several courts of bankruptcy under such section as a depository for the moneys of a bankrupt's estate, (*v*) pursuant to 6 U.S.C. 15, in lieu of a surety or sureties required in connection with any recognizance, stipulation, bond, guaranty, or undertaking which must be furnished under any law of the United States or regulations made pursuant thereto, (*vi*) by a banking institution, pursuant to a State or local law, to secure the deposit in such banking institution of public funds by a State, municipality, or other political subdivision, (*vii*) by a State bank or trust company or a national bank, pursuant to a State or local law, to secure the faithful performance of trust or other fiduciary obligations by such State bank or trust company or national bank, or (*viii*) to secure funds which are deposited or held in trust by a State bank or trust company or a national bank and are awaiting investment, but which are used by such State bank or trust company or national bank in the conduct of its business;

(*b*) The term "other security of the United States" means a bond, note, certificate of indebtedness, bill, debenture, or similar obligation which is subject to the provisions of 31 CFR Part 306 or other comparable Federal regulations and which is issued by (*1*) any department or agency of the Government of the United States, or (*2*) the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal Land Banks, the Federal Intermediate Credit Banks, the Banks for Cooperatives, or the Tennessee Valley Authority;

(*c*) The term "serially-numbered advice of transaction" means the confirmation (prescribed in 31 CFR 306.116) issued by the Reserve Bank which is identifiable by a unique number and indicates that a particular written instruction to the Reserve Bank with respect to the deposit or withdrawal of a specified book-entry security (or securities) has been executed; and

(*d*) The term "Reserve Bank" means a Federal Reserve Bank and its branches acting as Fiscal Agent of the United States.

(d) *Obligations issued as part of an investment unit.* For purposes of determining the basis of the individual elements of an investment unit (as defined in paragraph (b)(2)(ii)(*a*) of § 1.1232-3) consisting of an obligation and an option (which is not an excluded option under paragraph (b)(1)(iii)(*c*) of § 1.1232-3), security, or other property, the cost of such investment unit shall be allocated to such individual elements on the basis of their respective fair market values. In the case of the initial issuance of an investment unit consisting of an obligation and an option, security, or other property, where neither the obligation nor the option, security, or other property has a readily ascertainable fair market value, the portion of the cost of the unit which is allocable to the obligation shall be an amount equal to the issue price of the obligation as determined under paragraph (b)(2)(ii)(*a*) of § 1.1232-3.

(e) *Election as to certain regulated investment company stock*—(1) *General rule*—(i) *In general.* Notwithstanding paragraph (c) of this section, and except as provided in subdivision (ii) of this subparagraph, if—

(*a*) Shares of stock of a regulated investment company (as defined in subparagraph (5) of this paragraph) are left by a taxpayer in the custody of a custodian or agent in an account maintained for the acquisition or redemption of shares of such company, and

(*b*) The taxpayer purchased or acquired shares of stock held in the account at different prices or bases,

the taxpayer may elect to determine the cost or other basis of shares of stock he sells or transfers from such account by using one of the methods described in subparagraphs (3) and (4) of this paragraph. The cost or other basis determined in accordance with either of such methods shall be known as the "average basis". For purposes of this paragraph, securities issued by unit investment trusts shall be treated as shares of stock and the term "share" or "shares" shall include fractions of a share.

(ii) *Certain gift shares.* (*a*) Except as provided in subdivision (*b*) of this subdivision (ii), this paragraph shall not apply to any account which contains shares which were acquired by the taxpayer by gift after December 31, 1920, if the basis of such shares (adjusted for the period before the date of the gift as provided in section 1016) in the hands of the donor or the last preceding owner by whom it was not acquired by gift was greater than the fair market value of such shares at the time of the gift. However, shares acquired by a taxpayer as a result of a taxable dividend or a capital gain distribution from such an account may be included in an account to which this paragraph applies.

(*b*) Notwithstanding the provisions of subdivision (*a*) of this subdivision (ii), this paragraph shall apply with respect to accounts containing gift shares described in such subdivision (*a*) if, at the time the election described in this paragraph is made in the manner prescribed in subparagraph (6) of this paragraph, the taxpayer includes a statement, in writing, indicating that the basis of such gift shares shall be the fair market value of such gift shares at the time they were acquired by the taxpayer by gift and that such basis shall be used in computing average basis in the manner described in subparagraph (3) or (4) of this paragraph. Such statement shall be effective with respect to gift shares acquired prior to making such election and with respect to gift shares acquired after such time and shall remain in effect so long as such election remains in effect.

(2) *Determination of average basis.* Average basis shall be determined using either the method described in subparagraph (3) of this paragraph (the double-category method) or the method described in subparagraph (4) of this paragraph (the single-category method). The taxpayer shall specify, in the manner described in subparagraph (6) of this paragraph, the method used. Such method shall be used with respect to an account until such time as the election is revoked with the consent of the Commissioner. Although a taxpayer may specify different methods with respect to accounts in different regulated investment companies, the same method shall be used with respect to all of the taxpayer's accounts in the same regulated investment company.

(3) *Double-category method*—(i) *In general.* In determining average basis using the double category method, all shares in an account at the time of each sale or transfer shall be divided into two categories. The first category shall include all shares in such account having, at the time of the sale or transfer, a holding period of more than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) (the "more-than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) or less (the "1-year (6-months gory shall include all shares in such account having, at such time, a holding period of 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) or less (the "1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less" category). The cost or other basis of each share in a category shall be an amount equal to the remaining aggregate cost or other basis of all shares in that category at the time of the sale or transfer divided by the aggregate number of shares in that category at such time.

(ii) *Order of disposition of shares old or transferred.* Prior to a sale or transfer of shares from such an account, the taxpayer may specify, to the custodian or agent having custody of the account, from which category (described in subdivision (i) of this subparagraph) the shares are to be sold or transferred. Shares shall be deemed sold or transferred from the category specified without regard to the stock certificates, if any, actually delivered if, within a reasonable time thereafter, confirmation of such specification is set forth in a written document from the custodian or agent having custody of the account. In the absence of such specification or confirmation, shares sold or transferred shall be charged against the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category. However, if the number of shares sold or transferred exceeds the number in such category, the additional shares sold or transferred shall be charged against the shares in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category. Any gain or loss attributable to a sale or transfer which is charged against shares in the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category shall constitute long-term gain or loss, and any gain or loss attributable to a sale or transfer which is charged against shares in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category shall constitute short-term gain or loss. As to adjustments from wash sales, see section 1091(d) and subdivisions (iii) (*c*) and (*d*) of this subparagraph.

(iii) *Special rules with respect to shares from the 1 year-or-less category.* (*a*) After the taxpayer's holding period with respect to a share is more than 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977), such share shall be changed from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category to the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category. For purposes of such change, the basis of a changed share shall be its actual cost or other basis to the taxpayer or its basis determined in accordance with the rules contained in subdivision (*b*)(*2*) of this subdivision (iii) if the rules of such subdivision (*b*)(*2*) are applicable.

(*b*) If, during the period that shares are in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category some but not all of the shares in such category are sold or transferred, then—

(*1*) The shares sold or transferred (the basis of which was determined in the manner prescribed by subdivision (i) of this subparagraph) shall be assumed to be those shares in such category which were earliest purchased or acquired, and

(*2*) The basis of those shares which are not sold or transferred and which are changed from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category to the more-than-1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977) category shall be the average basis of the shares in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category at the time of the most recent sale or transfer of shares from such category. For such purposes, the average basis shall be determined in the manner prescribed in subdivision (i) of this subparagraph.

(*c*) Paragraph (a) of § 1.1091-2 contains examples which illustrate the general application of section 1091(d), relating to unadjusted basis in the case of a wash sale of stock. However, in the case of certain wash sales of stock from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category, the provisions of section 1091(d) shall be applied in the manner described in subdivision (*d*) of this subdivision (iii).

(*d*) In the case of a wash sale of stock (determined in accordance with the provisions of section 1091) from the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category which occurs after the acquisition of shares of stock into such category, the aggregate cost or other basis of all shares remaining in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category after such sale shall be increased by the amount of the loss which is not deductible because of the provisions of section 1091 and the regulations thereunder. The provisions of this subdivision may be illustrated by the following example:

Example. Assume the following acquisitions to, and sale from, the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category:

1-Year (6-Months for Taxable Years Beginning Before 1977; 9-Months for Taxable Years Beginning in 1977)-or-Less Category

Date	Action	Number shares	Price/share	Aggregate
1-5-71	Purchase	10	$110	$1,100
2-5-71	...do	10	100	1,000
3-5-71	...do	10	90	900
Average		30	100	3,000
3-15-71	Sale	10	90	900
	Loss	10	10	100

In this example, the unadjusted basis of the shares remaining in the account after the sale is $2,000 (aggregate basis of $3,000 before the sale, less $1,000, the aggregate basis of the shares sold after the averaging of costs). The adjusted basis of the shares remaining in the 1-year (6-months for taxable years beginning before 1977; 9-months for taxable years beginning in 1977)-or-less category after the sale and after adjustment is $2,100 (the unadjusted basis of $2,000, plus the $100 loss resulting from the sale).

(4) *Single-category method*—(i) *In general.* In determining average basis using the single-category method, the cost or other basis of all shares in an account at the time of each sale or transfer (whether such shares have a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less) shall be used in making the computation. The cost or other basis of each share in such account shall be an amount equal to the remaining aggregate cost or other basis of all shares in such account at the time of the sale or transfer divided by the aggregate number of shares in such account at such time.

(ii) *Order of disposition of shares sold or transferred.* In the case of the sale or transfer of shares from an account to which the election provided by this paragraph applies, and with respect to which the taxpayer has specified that he uses the single-category method of determining average basis, shares sold or transferred shall be deemed to be those shares first acquired. Thus, when shares are sold or transferred from an account such shares will be those with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) to the extent that such account contains shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). If the number of shares sold or transferred exceeds the number of shares in the account with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), any such excess shares sold or transferred will be deemed to be shares with a holding period of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. Any gain or loss attributable to shares held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall constitute long-term gain or loss, and any gain or loss attributable to shares held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less shall constitute short-term gain or loss. For example, if a taxpayer sells or transfers 50 shares from an account containing 100 shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and 100 shares with a holding period of 6 months or less, all of the shares sold or transferred will be deemed to be shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). If, however, the account contains 40 shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and 100 shares with a holding period of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less, the taxpayer will be deemed to have sold or transferred 40 shares with a holding period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and 10 shares with a holding period of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less.

(iii) *Restriction on use of single-category method.* The single-category method of determining average basis shall not be used where it appears from the facts and circumstances that a purpose of using such single-category method is to convert long-term capital gains or losses to short-term capital gains or losses or to convert short-term capital gains or losses to long-term capital gains or losses.

(iv) *Wash sales.* The provisions of section 1091(d) (relating to unadjusted basis in the case of a wash sale of stock) and the regulations thereunder shall apply in the case of wash sales of stock from an account with respect to which the single-category method of determining average basis is being used.

(5) *Definition.* (i) For purposes of this paragraph, a "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542) which meets the limitations of section 851(b) and § 1.851-2, and which is registered at all times during the taxable year under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company, or as a unit investment trust.

(ii) Notwithstanding subdivision (i), this paragraph shall not apply in the case of a unit investment trust unless it is one—

(*a*) Substantially all of the assets of which consist (*1*) of securities issued by a single management company (as defined in such Act) and securities acquired pursuant to subdivision (*b*) of this subdivision (ii), or (*2*) securities issued by a single other corporation, and

(*b*) Which has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(6) *Election.* (i) An election to adopt one of the methods described in this paragraph shall be made in an income tax return for the first taxable year ending on or after December 31, 1970, for which the taxpayer desires the election to apply. If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for such taxable year, the election shall be filed at the time the taxpayer files his first return for such year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for such taxable year. If the election is made, the taxpayer shall clearly indicate on his income tax return for each year to which the election is applicable that an average basis has been used in reporting gain or loss from the sale or transfer of shares sold or transferred. In addition, the taxpayer shall specify on such return the method (either the single-category method or the double-category method) used in determining average basis. The taxpayer shall also indicate in a statement described in subparagraph (1)(ii)(*b*) of this paragraph if the election is to apply to accounts described, in subparagraph (1)(ii) of this paragraph. Such statement shall be attached to, or incorporated in, such return. A taxpayer making the election shall maintain such records as are necessary to substantiate the average basis (or bases) used on his income tax return.

(ii) An election made with respect to some of the shares of a regulated investment company sold or transferred from an account described in subparagraph (1)(i) of this paragraph applies to all such shares in the account. Such election also applies to all shares of that regulated investment company held in other such accounts (*i.e.*, those described in subparagraph (1)(i) of this paragraph) by the electing taxpayer for his own benefit. Thus, the election shall apply to all shares of the regulated investment company held by the electing taxpayer (for his own benefit) in such accounts on or after the first day of the first taxable year for which the election is made. Such election does not apply to shares held in accounts described in subparagraph (1)(ii) of this paragraph unless the taxpayer indicates, in the manner described in subdivision (i) of this subparagraph, that the election is to apply to shares held in such accounts. An election made pursuant to the provisions of this paragraph may not be revoked without the prior written permission of the Commissioner.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) On January 11, 1971, taxpayer A, who files his income tax return on a calendar year basis, enters into an agreement with the W Bank establishing an account for the periodic acquisition of shares of the Y Company, an open-end mutual fund. The agreement provides (1) that the bank is to purchase, for A, shares of Y stock as A may from time to time direct, (2) that all shares in the account are to be left in the custody of the bank, and (3) that the bank is to reinvest any dividends paid by Y (including capital gain dividends) in additional shares of Y stock. Pursuant to the agreement, on January 11, 1971, February 1, 1971, and March 1, 1971, respectively, the bank purchases, at A's direction, 100 shares of Y stock for a total of $1,880, 20 shares of Y stock for a total of $400, and 20 shares of Y stock for a total of $410. On March 15, 1971, the bank reinvests a $1-per-share capital gain dividend (that is, a total of $140) in seven additional shares of Y stock. The acquisitions to A's account, are, therefore, as follows:

Date	Number of shares	Basis
Jan. 11, 1971	100	$1,880
Feb. 1, 1971	20	400
Mar. 1, 1971	20	410
Mar. 15, 1971	7	140

On August 20, 1971, at A's direction, the bank redeems (*i.e.*, sells) 40 shares of Y stock, and on September 20, 1971, 30 shares. A elects to determine the gain or loss from the sales of the stock by reference to its average basis using the double-category method of determining average basis. A did not specify from which category the sales were to take place, and therefore, each sale is deemed to have been made from the more-than-6-months category.

(ii) The average basis for the shares sold on August 20, 1971, is $19, and the total average basis for the 40 shares which are sold is $760, computed as follows:

Number of shares in the more-than-6-months category at the time of sale	Basis
100	$1,880
20	400
Total 120	2,280

Average cost or other basis: $2,280÷120=$19.40 shares ×$19 each=$760, total average basis. Therefore, after the sale on August 20, 1971, 80 shares remain in the more-than-6-months category, and their remaining aggregate cost is $1,520.

(iii) The average basis for the shares sold on September 20, 1971, must reflect the sale which was made on August 20, 1971. Accordingly, such average basis would be $19.35 and may be computed as follows:

Number of shares in the more-than-6-months category at the time of sale	Basis
80	$1,520
20	410
7	140
Total 107	2,070

Average cost or other basis: $2,070÷107 shares=$19.35 (to the nearest cent).

Example (2). Taxpayer B, who files his income tax returns on a calendar year basis, enters into an agreement with the X Bank establishing an account for the periodic acquisition of shares of the Z Company, an open-end mutual fund. X acquired for B's account shares of Z on the following dates in the designated amounts:

January 15, 1971	50 shares.
February 16, 1971	30 shares.
March 15, 1971	25 shares.

Pursuant to B's direction, the Bank redeemed (*i.e.*, sold) 25 shares from the account on February 1, 1971, and 20 shares on April 1, 1971, for a total of 45 shares. All of such shares had been held for less than 6 months. B elects to determine the gain or loss from the sales of the stock by reference to its average basis using the double-category method of determining average basis. Thus, the 45 shares which were sold are assumed to be from the 50 shares which were purchased on January 15, 1971. Accordingly, on July 16, 1971, only five shares from those shares which had been purchased on January 15, 1971, remain to be transferred from the 6-months-or-less category to the more-than-6-months category. The basis of such five shares for purposes of the change to the more-than-6-months category would be the average basis of the shares in the 6-months- or-less category at the time of the sale on April 1, 1971.

Example (3). Assume the same facts as in example (2), except that an additional sale of 18 shares was made on May 3, 1971. There were, therefore, a total of 63 shares sold during the 6-month period beginning on January 15, 1971, the date of the earliest purchase. Fifty of the shares which were sold during such period shall be assumed to be the shares purchased on January 15, 1971, and the remaining 13 shares shall be assumed to be from the shares which were purchased on February 16, 1971. Thus, none of the shares which were purchased on January 15, 1971, remain to be changed from the 6-months-or-less category to the more-than-6-months category. In the absence of further dispositions of shares during the 6-month holding period for the shares purchased on February 16, 1971, there would be 17 of such shares to be changed over after the expiration of that period since 13 of the shares sold on May 3, 1971, were assumed to be from the shares purchased on February 16, 1971. The basis of the 17 shares for purposes of the change to the more-than-6-months category would be the average basis of the shares in the 6-months-or-less category at the time of the sale on May 3, 1971.

Example (4). Taxpayer C, who files his income tax returns on a calendar year basis, enters into an agreement with Y Bank establishing an account for the periodic acquisition of XYZ Company, a closed-end mutual fund. Y acquired for B's account shares of XYZ on the following dates in the designated amounts:

Date	Number of shares	Cost
Jan. 8, 1971	25	$200
Feb. 8, 1971	24	200
Mar. 8, 1971	23	200
Apr. 8, 1971	23	200

Pursuant to C's direction, the bank redeemed (*i.e.,* sold) 40 shares from the account on July 15, 1971, for $10 per share or a total of $400. C elects to determine the gain or loss from the sale of the stock by reference to its average basis using the single-category method of determining average basis. The average basis for the shares sold on July 15, 1971 (determined by dividing the total number of shares in the account at such time (95) into the aggregate cost of such shares ($800)) is $8.42 (to the nearest cent). Under the rules of subparagraph (4) of this paragraph the shares sold would be deemed to be those first acquired. Thus, C would realize a $39.50 ($1.58×25) long-term capital gain with respect to the 25 shares acquired on January 8, 1971, and he would realize a $23.70 ($1.58×15 short-term capital gain with respect to 15 of the shares acquired on February 8, 1971. The next sale occurred on August 16, 1971. At that time, absent further intervening acquisitions or dispositions, the account contained nine shares (the 24 shares acquired on February 8, 1971, less 15 of such shares which were sold on July 15, 1971) with a holding period of more than 6 months, and 46 shares with a holding period of 6 months or less.

Example (5). Taxpayer D owns four separate accounts (D–1, D–2, D–3, and D–4) for the periodic acquisition of shares of the Y Company, an open-end mutual fund. Account D–4 contains shares which D acquired by gift on April 15, 1970. These shares had an adjusted basis in the hands of the donor which was greater than the fair market value of the donated shares on such date. For his taxable year ending on December 31, 1971, D elects to use an average basis for shares sold from account D–1 during such year using the single-category method of determining average basis. Under the provisions of subparagraph (1)(ii) of this paragraph, D may use an average basis for shares sold or transferred from account D–4 if he includes with his statement of election a statement, in writing, indicating that the basis of such gift shares in account D–4 shall be the fair market value of such shares at the time he acquired such shares and that such basis shall be used in computing the average basis of shares in account D–4. In addition, since D elected to use an average basis for shares sold from account D–1, he must also use an average basis for all shares sold or transferred from accounts D–2 and D–3 (as well as account D–1) for his taxable year ending on December 31, 1971, and for all subsequent years until he revokes (with the consent of the Commissioner) his election to use an average basis for such accounts. Further, D must use the single-category method of determining average basis with respect to accounts D–2, D–3 (and D–4 if the above-mentioned statement is filed).

(f) *Special rules.* For special rules for determining the basis for gain or loss in the case of certain vessels acquired through the Maritime Commission (or its successors) or pursuant to an agreement with the Secretary of Commerce, see sections 510, 511, and 607 of the

Merchant Marine Act, 1936, as amended (46 U.S.C. 1160, 1161) and Parts 2 and 3 of this Chapter. For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 1336. For special rules with respect to taxable years beginning before January 1, 1964, for determining the basis for gain or loss in the case of a disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see paragraph (b) of § 1.421-5. See section 423(c)(1) or 424(c)(1), whichever is applicable, for special rules with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a stock option described in such sections. See section 422(c)(1) for special rules with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of an exercise of a qualified stock option. For special rules with respect to certain exchanges creating original issue discount under the provisions of section 1232(b), see paragraph (b)(2)(iii)(*b*) of § 1.1232-3.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6837, 30 FR 8787, July 13, 1965; T.D. 6984, 33 FR 19176, Dec. 21, 1968; T.D. 7081, 35 FR 19996, Dec. 31, 1970; T.D. 7129, 36 FR 12736, July 7, 1971; 36 FR 13208, July 16, 1971; 36 FR 24997, Dec. 28, 1971; T.D. 7213, 37 FR 21992, Oct. 18, 1972; T.D. 7568, 43 FR 47505, Oct. 16, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1012-2 Transfers in part a sale and in part a gift.

For rules relating to basis of property acquired in a transfer which is in part a gift and in part a sale, see § 1.170A-4(c), § 1.1011-2(b), and § 1.105-4.

[T.D. 7207, 37 FR 20799, Oct. 5, 1972]

§ 1.1013-1 Property included in inventory.

The basis of property required to be included in inventory is the last inventory value of such property in the hands of the taxpayer. The requirements with respect to the valuation of an inventory are stated in subpart D (section 471 and following), part II, subchapter E, chapter 1 of the Code, and the regulations thereunder.

§ 1.1014-1 Basis of property acquired from a decedent.

(a) *General rule.* The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code of 1939. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see paragraph (e) of § 1.1014-3.

(b) *Scope and application.* With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of § 1.1014-2, including stock in a DISC or former DISC. In the case of stock in a DISC or former DISC, the provisions of this section and §§ 1.1014-2 through

1.1014-8 are applicable, except as provided in § 1.1014-9. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of § 1.1014-2. These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§ 1.1014-2 to 1.1014-6, inclusive, whenever the words "property acquired from a decedent" are used, they shall also mean "property passed from a decedent", and the phrase "person who acquired it from the decedent" shall include the "person to whom it passed from the decedent."

(c) *Property to which section 1014 does not apply.* Section 1014 shall have no application to the following classes of property:

(1) Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

(2) Restricted stock options described in section 421 which the employee has not exercised at death if the employee died before January 1, 1957. In the case of employees dying after December 31, 1956, see paragraph (d)(4) of § 1.421-5. In the case of employees dying in a taxable year ending after December 31, 1963, see paragraph (c)(4) of § 1.421-8 with respect to an option described in part II of subchapter D.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 413, Jan. 19, 1961; T.D. 6887, 31 FR 8812, June 24, 1966; T.D. 7283, 38 FR 20825, Aug. 3, 1973]

§ 1.1014-2 Property acquired from a decedent.

(a) *In general.* The following property, except where otherwise indicated, is considered to have been acquired from a decedent and the basis thereof is determined in accordance with the general rule in § 1.1014-1:

(1) Without regard to the date of the decedent's death, property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents. However, see paragraph (c)(1) of this section if the property was acquired by bequest or inheritance from a decedent dying after August 26, 1937, and if such property consists of stock or securities of a foreign personal holding company.

(2) Without regard to the date of the decedent's death, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

(4) Without regard to the date of the decedent's death, property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. (See section 2041(b) for definition of general power of appointment.)

(5) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in that property was includible in determining the value of the decedent's gross estate under part III, chapter 11 of the Internal Revenue Code of 1954 (relating to the estate tax) or section 811 of the Internal Revenue Code of 1939. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(6) In the case of decedents dying after December 31, 1950, and before

January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of that interest was required to be included in determining the value of the decedent's gross estate under section 811 of the Internal Revenue Code of 1939. It is necessary only that the value of a part of the survivor's interest in the annuity be includible in the gross estate under section 811. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(b) *Property acquired from a decedent dying after December 31, 1953*—(1) *In general.* In addition to the property described in paragraph (a) of this section, and except as otherwise provided in subparagraph (3) of this paragraph, in the case of a decedent dying after December 31, 1953, property shall also be considered to have been acquired from the decedent to the extent that both of the following conditions are met: (i) The property was acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), and (ii) the property is includible in the decedent's gross estate under the provisions of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, because of such acquisition. The basis of such property in the hands of the person who acquired it from the decedent shall be determined in accordance with the general rule in § 1.1014-1. See, however, § 1.1014-6 for special adjustments if such property is acquired before the death of the decedent. See also subparagraph (3) of this paragraph for a description of property not within the scope of this paragraph.

(2) *Rules for the application of subparagraph (1) of this paragraph.* Except as provided in subparagraph (3) of this paragraph, this paragraph generally includes all property acquired from a decedent, which is includible in the gross estate of the decedent if the decedent died after December 31, 1953. It is not necessary for the application of this paragraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable. Property acquired prior to the death of a decedent which is includible in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this paragraph. Also, this paragraph includes property acquired through the exercise or nonexercise of a power of appointment where such property is includible in the decedent's gross estate. It does not include property not includible in the decedent's gross estate such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States.

(3) *Exceptions to application of this paragraph.* The rules in this paragraph are not applicable to the following property:

(i) Annuities described in section 72;

(ii) Stock or securities of a foreign personal holding company as described in section 1014(b)(5) (see paragraph (c)(1) of this section);

(iii) Property described in any paragraph other than paragraph (9) of section 1014(b). See paragraphs (a) and (c) of this section.

In illustration of subdivision (ii), assume that A acquired by gift stock of a character described in paragraph (c)(1) of this section from a donor and upon the death of the donor the stock was includible in the donor's estate as being a gift in contemplation of death. A's basis in the stock would not be determined by reference to its fair market value at the donor's death under the general rule in section 1014(a). Furthermore, the special basis rules prescribed in paragraph (c)(1) of this section are not applicable to such property acquired by gift in contemplation of death. It will be necessary to refer to the rules in section 1015(a) to determine the basis.

(c) *Special basis rules with respect to certain property acquired from a decedent*—(1) *Stock or securities of a foreign personal holding company.* The basis of certain stock or securities of a foreign corporation which was a foreign personal holding company with respect to its taxable year next preceding the date of the decedent's death is governed by a special rule. If such stock was acquired from a decedent dying after August 26, 1937, by bequest or inheritance, or by the decedent's estate from the decedent, the basis of the property in the hands of the person who so acquired it (notwithstanding any other provision of section 1014) shall be the fair market value of such property at the date of the decedent's death or the adjusted basis of the stock in the hands of the decedent, whichever is lower.

(2) *Spouse's interest in community property of decedent dying after October 21, 1942, and on or before December 31, 1947.* In the case of a decedent dying after October 21, 1942, and on or before December 31, 1947, a special rule is provided for determining the basis of such part of any property, representing the surviving spouse's one-half share of property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the decedent's gross estate, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable upon the decedent's net estate. In such case the basis shall be the fair market value of such part of the property at the date of death (or the optional valuation elected under section 811(j) of the Internal Revenue Code of 1939) or the adjusted basis of the property determined without regard to this subparagraph, whichever is the higher.

§ 1.1014-3 Other basis rules.

(a) *Fair market value.* For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

(b) *Property acquired from a decedent dying before March 1, 1913.* If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 1053.

(c) *Reinvestments by a fiduciary.* The basis of property acquired after the death of the decedent by a fiduciary as an investment is the cost or other basis of such property to the fiduciary, and not the fair market value of such property at the death of the decedent. For example, the executor of an estate purchases stock of X company at a price of $100 per share with the proceeds of the sale of property acquired from a decedent. At the date of the decedent's death the fair market value of such stock was $98 per share. The basis of such stock to the executor or to a legatee, assuming the stock is distributed, is $100 per share.

(d) *Reinvestments of property transferred during life.* Where property is transferred by a decedent during life and the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent, the general rule stated in paragraph (a) of § 1.1014-1 shall not apply to such property. However, in such a case, the basis of any property acquired by such donee in exchange for the original property, or of any property acquired by the donee through reinvesting the proceeds of the sale of the original property, shall be the fair market value of the property thus acquired at the date of the decedent's death (or applicable alternate valuation date) if the property thus acquired is properly included in the decedent's gross estate for Federal estate tax purposes. These rules also apply to property acquired by the donee in any further exchanges or in further reinvestments. For example, on January 1, 1956, the decedent made a gift of real property to a trust for the benefit of his children, reserving to himself the power to revoke the trust at will. Prior to the decedent's death, the trustee sold the real property and invested the proceeds in stock of the Y company at $50 per share. At the time of the decedent's death, the value of such stock was $75 per share. The corpus of the trust was required to be included in the decedent's gross estate owing to his reservation of the power of revocation. The basis of the Y company stock following the decedent's death is $75 per share. Moreover, if the trustee sold the Y Company stock before the decedent's death for $65 a share and reinvested the proceeds in Z company stock which increased in value to $85 per share at the time of the decedent's death, the basis of the Z company stock following the decedent's death would be $85 per share.

(e) *Alternate valuation dates.* Section 1014(a) provides a special rule applicable in determining the basis of property described in § 1.1014-2 where—

(1) The property is includible in the gross estate of a decedent who died after October 21, 1942, and

(2) The executor elects for estate tax purposes under section 2032, or section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections.

In those cases, the value applicable in determining the basis of the property is not the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death if not distributed, sold, exchanged, or otherwise disposed of in the meantime. If such property was distributed, sold, exchanged, or otherwise disposed of within one year after the date of the decedent's death by the person who acquired it from the decedent, the value applicable in determining the basis is its value as of the date of such distribution, sale, exchange, or other disposition. For illustrations of the operation of this paragraph, see the estate tax regulations under section 2032.

§ 1.1014-4 Uniformity of basis; adjustment to basis.

(a) *In general.* (1) The basis of property acquired from a decedent, as determined under section 1014(a), is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. In determining the amount allowed or allowable to a taxpayer in computing taxable income as deductions for depreciation or depletion under section 1016(a)(2), the uniform basis of the property shall at all times be used and adjusted. The sale, exchange, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property. Moreover, any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition.

(2) Under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of the person taking the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise. Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of section 1014, and, for this reason, a common or uniform basis for all such interests. For example, if distribution of personal property left by a decedent is not

made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property. If the bequest is of the residue tc trustees in trust, and the executors do not distribute the residue to such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market value at the time when the decedent dies. If the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died. The purpose of the Code in prescribing a general uniform basis rule for property acquired from a decedent is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstances that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value resulting solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which is recognized as the measure of gain or loss.

(3) The principles stated in subparagraphs (1) and (2) of this paragraph do not apply to property transferred by an executor, administrator or trustee, to an heir, legatee, devisee or beneficiary under circumstances such that the transfer constitutes a sale or exchange. In such a case, gain or loss must be recognized by the transferor to the extent required by the revenue laws, and the transferee acquires a basis equal to the fair market value of the property on the date of the transfer. Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date.

(b) *Multiple interests.* Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis of computing gain or loss on the sale of any one of such multiple interests shall be determined under § 1.1014-5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. See § 1.1014-6 for adjustments in respect of property acquired from a decedent prior to his death.

(c) *Records.* The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require.

§ 1.1014-5 Gain or loss.

(a) *Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent.* (1) Except as provided in paragraph (b) of this section with respect to the sale or other disposition after October 9, 1969, of a term interest in property, gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest so transferred. The adjusted uniform basis is the uniform basis of the entire property adjusted to the date of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II of subchapter O of chapter 1 of the Code.

(2) Except as provided in paragraph (b) of this section, the proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which has been so transferred, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time.

(3) The factors set forth in the tables contained in § 20.2031-7 or § 20.2031-10, whichever is applicable, of Part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold. The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the age (on the date of the sale) of the person at whose death the life interest will terminate. In the case of the sale of a term certain interest, the factor used is the factor (adjusted where appropriate) which appears in the term certain column of the table opposite the number of years remaining (on the date of sale) before the term certain interest will terminate.

(b) *Sale or other disposition of certain term interests.* In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of § 1.1001-1) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and paragraph (f) of § 1.1001-1.

(c) *Illustrations.* The application of this section may be illustrated by the following examples, in which references are made to the actuarial tables contained in Part 20 of this chapter (Estate Tax Regulations):

Example (1). Securities worth $500,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to Table A(2) in paragraph (f) of § 20.2031-10, the life estate factor for age 48, female, is found to be 0.77488 and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000×0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000×0.22512). W sells her life interest to her nephew, A, on February 1, 1971, for $370,000, at which time W is still 48 years of age. Pursuant to section 1001(e), W realizes no loss; her gain is $370,000, the amount realized from the sale. A has a basis of $370,000 which he can recover by amortization deductions over W's life expectancy.

Example (2). The facts are the same as in example (1) except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to $650,000. By reference to Table A(2) in paragraph (f) of § 20.2031-10, the life estate factor for age 60, female, is found to be 0.63226 and the remainder factor for such age is found to be 0.36774. Therefore, the present value on February 1, 1983, of the portion of the uniform basis assigned to W's life interest is $316,130 ($500,000×0.63226) and the present value on that date of the portion of the uniform basis assigned to S's remainder interest is $183,870 ($500,000×0.36774). W sells her life interest for $410,969, that being the commuted value of her remaining life interest in the securities as appreciated ($650,000×0.63226). Pursuant to section 1001(e), W's gain is $410,969, the amount realized. A has a basis of $410,969 which he can recover by amortization deductions over W's life expectancy.

Example (3). Unimproved land having a fair market value of $18,800 at the date of the decedent's death on January 1, 1970, is devised to A, a male, for life, with remainder over to B, a female. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1971, A sells his life interest to S for $12,500. S is not related to A or B. At the time of the sale, A is 39 years of age. By reference to Table A(1) in paragraph (f) of § 20.2031-10, the life estate factor for age 39, male, is found to be 0.79854. Therefore, the present value of the portion of the uniform basis assigned to A's life interest is $15,012.55 ($18,800×0.79854). This portion is disregarded under section 1001(e). A realizes no loss; his gain is $12,500, the amount realized. S has a basis of $12,500 which he can recover by amortization deductions over A's life expectancy.

Example (4). The facts are the same as in example (3) except that on January 1, 1971, A and B jointly sell the entire property to S for $25,000 and divide the proceeds equally between them. A and B are not related, and there is no element of gift or compensation in the transaction. By reference to Table A(1) in paragraph (f) of § 20.2031-10, the remainder factor for age 39, male, is found to be 0.20146. Therefore, the present value of the uniform basis assigned to B's remainder interest is $3,787.45 ($18,800×0.20146). On the sale A realizes a loss of $2,512.55 ($15,012.55 less $12,500), the portion of the uniform basis assigned to his life interest not being disregarded by reason of section 1001(e)(3). B's gain on the sale is $8,712.55 ($12,500 less $3,787.45). S has a basis in the entire property of $25,000, no part of which, however, can be recovered by amortization deductions over A's life expectancy.

Example (5). (a) Nondepreciable property having a fair market value of $54,000 at the date of decedent's death on January 1, 1971, is devised to her husband, H, for life and, after his death, to her daughter, D, for life, with remainder over to her grandson, G. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1973, H sells his life interest to D for $32,000. At the date of the sale, H is 62 years of age, and D is 45 years of age. By reference to Table A(1) in paragraph (f) of

§ 20.2031-10, the life estate factor for age 62, male, is found to be 0.52321. Therefore, the present value on January 1, 1973, of the portion of the adjusted uniform basis assigned to H's life interest is $28,253 ($54,000×0.52321). Pursuant to section 1001(e), H realizes no loss; his gain is $32,000, the amount realized from the sale. D has a basis of $32,000 which she can recover by amortization deductions over H's life expectancy.

(b) On January 1, 1976, D sells both life estates to G for $40,000. During each of the years 1973 through 1975, D is allowed a deduction for the amortization of H's life interest. At the date of the sale H is 65 years of age, and D is 48 years of age. For purposes of determining gain or loss on the sale by D, the portion of the adjusted uniform basis assigned to H's life interest and the portion assigned to D's life interest are not taken into account under section 1001(e). However, pursuant to § 1.1001-1(f)(1), D's cost basis in H's life interest, minus deductions for the amortization of such interest, is taken into account. On the sale, D realizes gain of $40,000 minus an amount which is equal to the $32,000 cost basis (for H's life estate) reduced by amortization deductions. G is entitled to amortize over H's life expectancy that part of the $40,000 cost which is attributable to H's life interest. That part of the $40,000 cost which is attributable to D's life interest is not amortizable by G until H dies.

Example (6). Securities worth $1,000,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to Table A(2) in paragraph (f) of § 20.2031-10, the life estate factor for age 48, female, is found to be 0.77488, and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $774,880 ($1,000,000×0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $225,120 ($1,000,000×0.22512). On February 1, 1971, W transfers her life interest to corporation X in exchange for all of the stock of X pursuant to a transaction in which no gain or loss is recognized by reason of section 351. On February 1, 1972, W sells all of her stock in X to S for $800,000. Pursuant to section 1001(e) and § 1.1001-1(f)(2), W realizes no loss; her gain is $800,000, the amount realized from the sale. On February 1, 1972, X sells to N for $900,000 the life interest transferred to it by W. Pursuant to section 1001(e) and § 1.1001-1(f)(1), X realizes no loss; its gain is $900,000, the amount realized from the sale. N has a basis of $900,000 which he can recover by amortization deductions over W's life expectancy.

[T.D. 7142, 36 FR 18951, Sept. 24, 1971]

§ 1.1014-6 Special rule for adjustments to basis where property is acquired from a decedent prior to his death.

(a) *In general.* (1) The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death. Thus, in general, the adjusted basis of such property will be its fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed (determined with regard to section 1016(a)(2)(B)) to the taxpayer as deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion for the period held by the taxpayer prior to the decedent's death. The deduction allowed for a taxable year in which the decedent dies shall be an amount properly allocable to that part of the year prior to his death. For a discussion of the basis adjustment required by section 1014(b)(9) where property is held in trust, see paragraph (c) of this section.

(2) Where property coming within the purview of subparagraph (1) of this paragraph was held by the decedent and his surviving spouse as tenants by the entirety or as joint tenants with right of survivorship, and joint income tax returns were filed by the decedent and the surviving spouse in which the deductions referred to in subparagraph (1) were taken, there shall be allocated to the surviving spouse's interest in the property that proportion of the deductions allowed for each period for which the joint returns were filed which her income from the property bears to the total income from the property. Each spouse's income from the property shall be determined in accordance with local law.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). The taxpayer acquired income-producing property by gift on January 1, 1954. The property had a fair market value of $50,000 on the date of the donor's death, January 1, 1956, and was included in his gross estate at that amount for estate tax purposes as a transfer in contemplation of death. Depreciation in the amount of $750 per year was allowable for each of the taxable years 1954 and 1955. However, the taxpayer claimed depreciation in the amount of $500 for each of these years (resulting in a reduction in his taxes) and his income tax returns were accepted as filed. The adjusted basis of the property as of the date of the decedent's death is $49,000 ($50,000, the fair market value at the decedent's death, less $1,000, the total of the amounts actually allowed as deductions).

Example (*2*). On July 1, 1952, H purchased for $30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was $40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was $500 and for each of the other years 1953 and 1954 was $1,000. One-half of the $2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was $38,750 ($40,000, value on the date of H's death, less $1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be $40,000.

(b) *Multiple interests in property described in section 1014(b)(9) and acquired from a decedent prior to his death.* (1) Where more than one person has an interest in property described in section 1014(b)(9) which was acquired from a decedent before his death, the basis of such property and of each of the several interests therein shall, in general, be determined and adjusted in accordance with the principles contained in §§ 1.1014-4 and 1.1014-5, relating to the uniformity of basis rule. Application of these principles to the determination of basis under section 1014(b)(9) is shown in the remaining subparagraphs of this paragraph in connection with certain commonly encountered situations involving multiple interests in property acquired from a decedent before his death.

(2) Where property is acquired from a decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, the uniform basis of the property, as well as the basis of each of the several interests in the property, shall be determined by taking into account the basis adjustments required by section 1014(a) owing to such inclusion of the entire property in the decedent's gross estate. For example, suppose that the decedent transfers property in trust, with a life estate to A, and the remainder to B or his estate. The transferred property consists of 100 shares of the common stock of X Corporation, with a basis of $10,000 at the time of the transfer. At the time of the decedent's death the value of the stock is $20,000. The transfer is held to have been made in contemplation of death and the entire value of the trust is included in the decedent's gross estate. Under section 1014(a), the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, is $20,000. If immediately prior to the decedent's death, A's share of the uniform basis of $10,000 was $6,000, and B's share was $4,000, then, immediately after the decedent's death, A's share of the uniform basis of $20,000 is $12,000, and B's share is $8,000.

(3)(i) In cases where, due to the operation of the estate tax, only a portion of property acquired from a decedent before his death is included in the decedent's gross estate, as in cases where the decedent retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property shall be determined by taking into account any basis adjustments required by section 1014(a) owing to such inclusion of a portion of the property in the decedent's gross estate. In such cases the uniform basis is the adjusted basis of the entire property immediately prior to the decedent's death increased (or decreased) by an amount which bears the same relation to the total appreciation (or diminution) in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value of the property included in the decedent's gross estate bears to the value of the entire property. For example, assume that the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent should survive A, the income shall be paid to the decedent for life. Assume that the decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the common stock of X Corporation with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death, the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. The uniform basis of the entire property following the decedent's death is $14,000, computed as follows:

Uniform basis prior to decedent's death	$10,000
plus	
Increase in uniform basis (determined by the following formula)	4,000
[Increase in uniform basis (to be determined)/ $10,000 (total appreciation)] =	
[$8,000 (value of property included in gross estate)/$20,000 (value of entire property)]	
Uniform basis under section 1014(a)	14,000

(ii) In cases of the type described in subdivision (i) of this subparagraph, the basis of any interest which is included in the decedent's gross estate may be ascertained by adding to (or subtracting from) the basis of such interest determined immediately prior to the decedent's death the increase (or decrease) in the uniform basis of the property attributable to the inclusion of the interest in the decedent's gross estate. Where the interest is sold or otherwise disposed of at any time after the decedent's death, proper adjustment must be made in order to reflect the change in value of the interest on account of the passage of time, as provided in § 1.1014-5. For an illustration of the operation of this subdivision, see step 6 of the example in § 1.1014-7.

(iii) In cases of the type described in subdivision (i) of this subparagraph (cases where, due to the operation of the estate tax, only a portion of the property is included in the decedent's gross estate), the basis for computing the depreciation, amortization, or depletion allowance shall be the uniform basis of the property determined under section 1014(a). However, the manner of taking into account such allowance computed with respect to such uniform basis is subject to the following limitations:

(*a*) In cases where the value of the life interest is not included in the decedent's gross estate, the amount of such allowance to the life tenant under section 167(h) (or section 611(b)) shall not exceed (or be less than) the amount which would have been allowable to the life tenant if no portion of the basis of the property was determined under section 1014(a). Proper adjustment shall be made for the amount allowable to the life tenant, as required by section 1016. Thus, an appropriate adjustment shall be made to the uniform basis of the property in the hands of the trustee, to the basis of the life interest in the hands of the life tenant, and to the basis of the remainder in the hands of the remainderman.

(*b*) Any remaining allowance (that is, the increase in the amount of depreciation, amortization, or depletion allowable resulting from any increase in the uniform basis of the property under section 1014(a)) shall not be allowed to the life tenant. The remaining allowance shall, instead, be allowed to the trustee to the extent that the trustee both (*1*) is required or permitted, by the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion, and (*2*) actually maintains such a reserve. If, in accordance with the preceding sentence, the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under section 1016, in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainderman, but shall not be taken into account, under section 1016, in determining the basis of the life interest in the hands of the life tenant. For an example of the operation of this subdivision, see paragraph (b) of § 1.1014-7.

(4) In cases where the basis of any interest in property is not determined under section 1014(a), as where such interest (i) is not included in the decedent's gross estate, or (ii) is sold, exchanged or otherwise disposed of before the decedent's death, the basis of such interest shall be determined under other applicable provisions of the Code. To illustrate, in the example shown in subparagraph (3)(i) of this paragraph the basis of the life estate in the hands of A shall be determined under section 1015, relating to the basis of property acquired by gift. If, on the other hand, A had sold his life interest prior to the decedent's death, the basis of the life estate in the hands of A's transferee would be determined under section 1012.

(c) *Adjustments for deductions allowed prior to the decedent's death.* (1) As stated in paragraph (a) of this section, section 1014(b)(9) requires a reduction in the uniform basis of property acquired from a decedent before his death for certain deductions allowed in respect of such property during the decedent's lifetime. In general, the amount of the reduction in basis required by section 1014(b)(9) shall be the aggregate of the deductions allowed in respect of the property, but shall not include deductions allowed in respect of the property to the decedent himself. In cases where, owing to the operation of the estate tax, only a part of the value of the entire property is included in the decedent's gross estate, the amount of the reduction required by section 1014(b)(9) shall be an amount which bears the same relation to the total of all deductions (described in paragraph (a) of this section) allowed in respect of the property as the value of the property included in the decedent's gross estate bears to the value of the entire property.

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The property transferred in trust consists of an apartment building with a basis of $50,000 at the time of the transfer. The decedent dies 2 years after the transfer is made and the gift is held to have been made in contemplation of death. Depreciation on the property was allowed in the amount of $1,000 annually. At the time of the decedent's death the value of the property is $58,000. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, immediately after the decedent's death is $56,000 ($58,000, fair market value of the property immediately after the decedent's death, reduced by $2,000, deductions for depreciation allowed prior to the decedent's death).

Example (2). The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent predeceases A and the present value of the remainder interest is included in the decedent's gross estate for estate tax purposes. The property transferred consists of an apartment building with a basis of $110,000 at the time of the transfer. Following the creation of the trust and during the balance of the decedent's life, deductions for depreciation were allowed on the property in the amount of $10,000. At the time of decedent's death the value of the entire property is $150,000, and the value of the remainder interest is $100,000. Accordingly, the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, as adjusted under section 1014(b)(9), is $126,666, computed as follows:

Uniform basis prior to decedent's death	$100,000
plus	
Increase in uniform basis—before reduction (determined by the following formula)	33,333
[Increase in uniform basis (to be determined)/ $50,000 (total appreciation of property since time of transfer)] =	
[$100,000 (value of property included in gross estate)/$150,000 (value of entire property)]	
less	133,333
Deductions allowed prior to decedent's death—taken into account under section 1014(b)(9) (determined by the following formula)	6,667
[Prior deductions taken into account (to be determined) $10,000 (total deductions allowed prior to decedent's death)] =	
[$100,000 (value of property included in gross estate) $150,000 (value of entire property)]	
Uniform basis under section 1014	126,666

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3656, Mar. 24, 1964; T.D. 7142, 36 FR 18952, Sept. 24, 1971]

§ 1.1014–7 Example applying rules of §§ 1.1014–4 through 1.1014–6 to case involving multiple interests.

(a) On January 1, 1950, the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent, who died on January 1, 1955, predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of an apartment building with a basis of $30,000 at the time of transfer. Under the trust instrument the trustee is required to maintain a reserve for depreciation. During the decedent's lifetime depreciation is allowed in the amount of $800 annually. At the time of the decedent's death the value of the apartment building is $45,000. A, the life tenant, is 43 years of age at the time of the decedent's death. Immediately after the decedent's death, the uniform basis of the entire property under section 1014(a) is $32,027; A's basis for the life interest is $15,553; and B's basis for the remainder interest is $16,474, computed as follows:

Step 1. Uniform basis (adjusted) immediately prior to decedent's death:		
Basis at time of transfer		$30,000
less		
Depreciation allowed under section 1016 before decedent's death ($800×5)		4,000
		26,000
Step 2. Value of property included in decedent's gross estate:		
0.40180 (remainder factor, age 43) ×$45,000 (value of entire property)		18,081
Step 3. Uniform basis of property under section 1014(a), before reduction required by section 1014(b)(9):		
Uniform basis (adjusted) prior to decedent's death		26,000
Increase in uniform basis (determined by the following formula)		7,634
Increase in uniform basis (to be determined) $19,000 (total appreciation, $45,000−$26,000)] =		
$18,081 (value of property included in gross estate) $45,000 (value of entire property)]		
		33,634
Step 4. Uniform basis reduced as required by section 1014(b)(9) for deductions allowed prior to death:		
Uniform basis before reduction		33,634
less		
Deductions allowed prior to decedent's death—taken into account under section 1014(b)(9) (determined by the following formula)		$1,607
Prior deductions taken into account (to be determined) $4,000 (total deductions allowed prior to decedent's death)] =		
$18,081 (value of property included in gross estate) $45,000 (value of entire property)		
		32,027
Step 5. A's basis for the life interest at the time of the decedent's death, determined under section 1015: 0.59820 (life factor, age 43) × $26,000		15,553
Step 6. B's basis for the remainder interest, determined under section 1014(a): Basis prior to the decedent's death:		
0.40180 (remainder factor, age 43) × $26,000		10,447
plus		
Increase in uniform basis owing to decedent's death:		
Increase in uniform basis	$7,634	
plus		
Reduction required by section 1014(b)(9)	1,607	
		6,027
		16,474

(b) Assume the same facts as in paragraph (a) of this section. Assume further, that following the decedent's death depreciation is allowed in the amount of $1,000 annually. As of January 1, 1964, when A's age is 52, the adjusted uniform basis of the entire property is $23,027; A's basis for the life interest is $9,323; and B's basis for the remainder interest is $13,704, computed as follows:

Step 7. Uniform basis (adjusted) as of January 1, 1964:	
Uniform basis determined under section 1014(a), reduced as required by section 1014(b)(9)	$32,027
less	
Depreciation allowed since decedent's death ($1,000×9)	9,000
	23,027
Step 8. Allocable share of adjustment for depreciation allowable in the nine years since the decedent's death:	
A's interest	
0.49587 (life factor, age 52) ×$7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), ×9)	3,570
B's interest	
0.50413 (remainder factor, age 52) ×$7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), ×9)	3,630
plus	
$200 (annual depreciation attributable to increase in uniform basis under section 1014(a)) ×9	1,800
	5,430

Step 9. Tentative bases of A's and B's interests as of January 1, 1964 (before adjustment for depreciation).

A's interest	
0.49587 (life factor, age 52) ×$26,000 (adjusted uniform basis immediately before decedent's death)	$12,893
B's interest	
0.50413 (remainder factor, age 52) ×$26,000 (adjusted uniform basis immediately before decedent's death)	13,107
plus	
Increase in uniform basis owing to inclusion of remainder in decedent's gross estate	6,027
	19,134

Step 10. Bases of A's and B's interests as of January 1, 1964.

A	
Tentative basis (Step 9)	12,893
less	
Allocable depreciation (Step 8)	3,570
	9,323
B	
Tentative basis (Step 9)	19,134
less	
Allocable depreciation (Step 8)	5,430
	13,704

§ 1.1014–8 Bequest, devise, or inheritance of a remainder interest.

(a)(1) Where property is transferred for life, with remainder in fee, and the remainderman dies before the life tenant, no adjustment is made to the uniform basis of the property on the death of the remainderman (see paragraph (a) of § 1.1014–4). However, the basis of the remainderman's heir, legatee, or devisee for the remainder interest is determined by adding to (or subtracting from) the part of the adjusted uniform basis assigned to the remainder interest (determined in accordance with the principles set forth in §§ 1.1014–4 through 1.1014–6) the difference between—

(i) The value of the remainder interest included in the remainderman's estate, and

(ii) The basis of the remainder interest immediately prior to the remainderman's death.

(2) The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee) shall be determined by adding to (or subtracting from) the adjusted uniform basis of the property thus distributed the difference between—

(i) The value of the remainder interest in the property included in the remainderman's estate, and

(ii) The basis of the remainder interest in the property immediately prior to the remainderman's death.

(b) The provisions of paragraph (a) of this section are illustrated by the following examples:

Example (1). Assume that, under the will of a decedent, property consisting of common stock with a value of $1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is $1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (0.34185, remainder factor age 37, ×$1,600), and hence $547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is $596, computed as follows:

Basis of remainder interest computed with respect to uniform basis of entire property (0.39131, remainder factor age 42, ×$1,000, uniform basis of entire property)		$391
plus		
Value of remainder interest included in B's estate	$547	
less		
Basis of remainder interest immediately prior to B's death (0.34185, remainder factor age 37, ×$1,000)	342	
		205
Basis of C's remainder interest at the time of sale		596

Example (2). Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust		$1,000
plus		
Value of remainder interests in the property at the time of B's death	$547	
less		
B's share of uniform basis of the property at the time of his death	342	
		205
C's basis for the stock distributed to him upon the termination of the trust		1,205

Example (3). Assume the same facts as in example (2), except that the property transferred is depreciable. Assume further that

$100 of depreciation was allowed prior to B's death and that $50 of depreciation is allowed between the time of B's death and the termination of the trust. Upon A's death terminating the trust, C's basis for the property distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust:		
Uniform basis immediately after decedent's death	$1,000	
Depreciation allowed following decedent's death	150	
		$350
plus		
Value of remainder interest in the property at the time of B's death	547	
less		
B's share of uniform basis of the property at the time of his death (0.34185×$900, uniform basis at B's death)	308	
		239
C's basis for the property distributed to him upon the termination of the trust		1,089

(c) The rules stated in paragraph (a) of this section do not apply where the basis of the remainder interest in the hands of the remainderman's transferee is determined by reference to its cost to such transferee. See also paragraph (a) of § 1.1014-4. Thus, if, in example (*1*) of paragraph (b) of this section B sold his remainder interest to C for $547 in cash, C's basis for the stock distributed to him upon the death of A terminating the trust is $547.

§ 1.1014-9 Special rule with respect to DISC stock.

(a) *In general.* If property consisting of stock of a DISC or former DISC (as defined in section 992(a) (1) or (3) as the case may be) is considered to have been acquired from a decedent (within the meaning of paragraph (a) or (b) of § 1.1014-2), the uniform basis of such stock under section 1014, as determined pursuant to §§ 1.1014-1 through 1.1014-8 shall be reduced as provided in this section. Such uniform basis shall be reduced by the amount (hereinafter referred to in this section as the amount of reduction), if any, which the decedent would have included in his gross income under section 995(c) as a dividend if the decedent had lived and sold such stock at its fair market value on the estate tax valuation date. If the alternate valuation date for Federal estate tax purposes is elected under section 2032, in computing the gain which the decedent would have had if he had lived and sold the stock on the alternate valuation date, the decedent's basis shall be determined with reduction for any distributions with respect to the stock which may have been made, after the date of the decedent's death and on or before the alternate valuation date, from the DISC's previously taxed income (as defined in section 996(f)(2)). For this purpose, the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock) shall not apply. For purposes of this section, if the corporation is not a DISC or former DISC at the date of the decedent's death but is a DISC for a taxable year which begins after such date and on or before the alternate valuation date, the corporation will be considered to be a DISC or former DISC only if the alternate valuation date is elected. The provisions of this paragraph apply with respect to stock of a DISC or former DISC which is included in the gross estate of the decedent, including but not limited to property which—

(1) Is acquired from the decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, or

(2) Is acquired property described in paragraph (d) of § 1.1014-3.

(b) *Portion of property acquired from decedent before his death included in decedent's gross estate*—(1) *In general.* In cases where, due to the operation of the estate tax, only a portion of property which consists of stock of a DISC or former DISC and which is acquired from a decedent before his death is included in the decedent's gross estate, the uniform basis of such stock under section 1014, as determined pursuant to §§ 1.1014-1 through 1.1014-8, shall be reduced by an amount which bears the same ratio to the amount of reduction which would have been determined under paragraph (a) of this section if the entire property consisting of such stock were included in the decedent's gross estate as the value of such property included in the decedent's gross estate bears to the value of the entire property.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. The decedent creates a trust during his lifetime to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent shall survive A, the income shall be paid to the decedent for life. The decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the stock of X corporation (which is a DISC at the time the shares are transferred to the trust and at the time of the decedent's death) with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. Applying the principles of paragraph (b)(3)(i) of § 1.1014-6, the uniform basis of the entire property following the decedent's death, prior to reduction pursuant to this paragraph, is $14,000. The amount of reduction which would have been determined under paragraph (a) of this section if the entire property consisting of such stock of X corporation were included in the decedent's gross estate is $5,000. The uniform basis of the entire property following the decedent's death, as reduced pursuant to this paragraph, is $12,000, computed as follows:

Uniform basis under section 1014(a), prior to reduction pursuant to this paragraph	$14,000
Less decrease in uniform basis (determined by the following formula)	2,000
[Reduction in uniform basis (to be determined)/ $5,000 (amount of reduction if paragraph (a) applied)] =	
[$8,000 (value of property included in gross estate/$20,000 (value of entire property)]	
Uniform basis under section 1014(a) reduced pursuant to this paragraph	12,000

(c) *Estate tax valuation date.* For purposes of section 1014(d) and this section, the estate tax valuation date is the date of the decedent's death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). At the date of A's death, his DISC stock has a fair market value of $100. The estate does not elect the alternate valuation allowed by section 2032, and A's basis in such stock is $60 at the date of his death. The person who acquires such stock from the decedent will take as a basis for such stock its fair market value at A's death ($100), reduced by the amount which would have been included in A's gross income under section 995(c) as a dividend if A had sold stock on the date he died. Thus, if the amount that would have been treated as a dividend under section 995(c) were $30, such person will take a basis of $70 for such stock ($100, reduced by $30). If such person were immediately to sell the DISC stock so received for $100, $30 of the proceeds from the sale would be treated as a dividend by such person under section 995(c).

Example (2). Assume the same facts as in example (1) except that the estate elects the alternate valuation allowed by section 2032, the DISC stock has a fair market value of $140 on the alternate valuation date, the amount that would have been treated as a dividend under section 995(c) in the event of a sale on such date is $50 and the DISC has $20 of previously taxed income which accrued after the date of the decedent's death and before the alternate valuation date. The basis of the person who acquires such stock will be $90 determined as follows:

(1) Fair market value of DISC stock at alternate valuation date	$140
(2) Less: Amount which would have been treated as a dividend under section 995(c)	50
(3) Basis of person who acquires DISC stock	90

If a distribution of $20 attributable to such previously taxed income had been made by the DISC on or before the alternate valuation date (with the DISC stock having a fair market value of $120 after such distribution), the basis of the person who acquires such stock will be $70 determined as follows:

(1) Fair market value of DISC stock at alternate valuation date	$120
(2) Less: Amount which would have been treated as a dividend under section 995(c)	50
(3) Basis of person who acquires DISC stock	70

[T.D. 7283, 38 FR 20825, Aug. 3, 1973]

§ 1.1015-1 Basis of property acquired by gift after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise), the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis (adjusted for the period prior to the date of gift in accordance with sections 1016 and 1017) is greater than the fair market value of the property at the time of the gift. In such case, the basis for determining loss is the fair market value at the time of the gift.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example.

Example. A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

(3) If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to the donee, the district director shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the district director finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the district director as of the date or approximate date at which, according to the best information the district director is able to obtain, such property was acquired by such donor or last preceding owner. See paragraph (e) of this section for rules relating to fair market value.

(b) *Uniform basis; proportionate parts of.* Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1015, that part of the adjusted uniform basis assignable under the rules of § 1.1014- 5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f).

(c) *Time of acquisition.* The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. Thus, the date that the donee acquires an interest in property by gift where he is a successor in interest, such as in the case of a remainderman of a life estate or a beneficiary of the distribution of the corpus of a trust, is the date such interests are created by the donor and not the date the property is actually acquired.

(d) *Property acquired by gift from a decedent dying after December 31, 1953.* If an interest in property was acquired by the taxpayer by gift from a donor dying after December 31, 1953, under conditions which required the inclusion of the property in the donor's gross estate for estate tax purposes, and the property had not been sold, exchanged, or otherwise disposed of by the taxpayer before the donor's death, see the rules prescribed in section 1014 and the regulations thereunder.

(e) *Fair market value.* For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or, if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax, shall be deemed to be the fair market value of the property at the time of the gift.

(f) *Reinvestments by fiduciary.* If the property is an investment by the fiduciary under the terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

(g) *Records.* To insure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7142, 36 FR 18952, Sept. 24, 1971]

§ 1.1015-2 Transfer of property in trust after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

(2) The principles stated in paragraph (b) of § 1.1015-1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

(b) *Reinvestment by fiduciary.* If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

§ 1.1015-3 Gift or transfer in trust before January 1, 1921.

(a) In the case of property acquired by gift or transfer in trust before January 1, 1921, the basis of such property is the fair market value thereof at the time of the gift or at the time of the transfer in trust.

(b) The principles stated in paragraph (b) of § 1.1015-1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by gift or transfer in trust before January 1, 1921. In addition, if an interest in such property was acquired from a decedent and the property had not been sold, exchanged, or otherwise disposed of before the death of the donor, the rules prescribed in section 1014 and the regulations thereunder are applicable in determining the basis of such property in the hands of the taxpayer.

§ 1.1015-4 Transfers in part a gift and in part a sale.

(a) *General rule.* Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of—

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) The se amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015-5).

For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see § 1.1001-1(e) and § 1.1011-2. For special rule where there has been a charitable contribution of less than a taxpayer's entire interest in property, see section 170(e)(2) and § 1.170A-4(c).

(b) *Examples.* The rule of paragraph (a) of this section is illustrated by the following examples:

Example (1). If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example (2). If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (3). If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (4). If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son ins $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7207, 37 FR 20799, Oct. 5, 1972]

§ 1.1015-5 Increased basis for gift tax paid.

(a) *General rule.* (1)(i) Subject to the conditions and limitations provided in section 1015(d), as added by the Technical Amendments Act of 1958, the basis (as determined under section 1015(a) and paragraph (a) of § 1.1015-1) of property acquired by gift is increased by the amount of gift tax paid with respect to the gift of such property. Under section 1015(d)(1)(A), such increase in basis applies to property acquired by gift on or after September 2, 1958 (the date of enactment of the Technical Amendments Act of 1958). Under section 1015(d)(1)(B), such increase in basis applies to property acquired by gift before September 2, 1958, and not sold, exchanged, or otherwise disposed of before such date. If section 1015(d)(1)(A) applies, the basis of the property is increased as of the date of the gift regardless of the date of payment of the gift tax. For example, if the property was acquired by gift on September 8, 1958, and sold by the donee on October 15, 1958, the basis of the property would be increased (subject to the limitation of section 1015(d)) as of September 8, 1958 (the date of the gift), by the amount of gift tax applicable to such gift even though such tax was not paid until March 1, 1959. If section 1015(d)(1)(B) applies, any increase in the basis of the property due to gift tax paid (regardless of date of payment) with respect to the gift is made as of September 2, 1958. Any increase in basis under section 1015(d) can be no greater than the amount by which the fair market value of the property at the time of the gift exceeds the basis of such property in the hands of the donor at the time of the gift. See paragraph (b) of this section for rules for determining the amount of gift tax paid in respect of property transferred by gift.

(ii) With respect to property acquired by gift before September 2, 1958, the provisions of section 1015(d) and this section do not apply if, before such date, the donee has sold, exchanged, or otherwise disposed of such property. The phrase "sold, exchanged, or otherwise disposed of" includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to section 331. It also includes the exchange of property for property of a like kind such as the exchange of one apartment house for another. The phrase does not, however, extend to transactions which are mere changes in form. Thus, it does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under section 351. Nor does it include an exchange of stock or securities in a corporation for stock or securities in the same corporation or another corporation in a transaction such as a merger, recapitalization, reorganization, or other transaction described in section 368(a) or 355, with respect to which no gain or loss is recognizable for income tax purposes under section 354 or 355. If a binding contract for the sale, exchange, or other disposition of property is entered into, the property is considered as sold, exchanged, or otherwise disposed of on the effective date of the contract, unless the contract is not subsequently carried out substantially in accordance with its terms. The effective date of a contract is normally the date it is entered into (and not the date it is consummated, or the date legal title to the property passes) unless the contract specifies a different effective date. For purposes of this subdivision, in determining whether a transaction comes within the phrase "sold, exchanged, or otherwise disposed of", if a transaction would be treated as a mere change in the form of the property if it occurred in a taxable year subject to the Internal Revenue Code of 1954, it will be so treated if the transaction occurred in a taxable year subject to the Internal Revenue Code of 1939 or prior revenue law.

(2) Application of the provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). In 1938, A purchased a business building at a cost of $120,000. On September 2, 1958, at which time the property had an adjusted basis in A's hands of $60,000, he gave the property to his nephew, B. At the time of the gift to B, the property had a fair market value of $65,000 with respect to which A paid a gift tax in the amount of $7,545. The basis of the property in B's hands at the time of the gift, as determined under section 1015(a) and § 1.1015-1, would be the same as the adjusted basis in A's hands at the time of the gift, or $60,000. Under section 1015(d) and this section, the basis of the building in B's hands as of the date of the gift would be increased by the amount of the gift tax paid with respect to such gift, limited to an amount by which the fair market value of the property at the time of the gift exceeded the basis of the property in the hands of A at the time of gift, or $5,000. Therefore, the basis of the property in B's hands immediately after the gift, both for determining gain or loss on the sale of the property, would be $65,000.

Example (2). C purchased property in 1938 at a cost of $100,000. On October 1, 1952, at which time the property had an adjusted basis of $72,000 in C's hands, he gave the property to his daughter, D. At the date of the gift to D, the property had a fair market value of $85,000 with respect to which C paid a gift tax in the amount of $11,745. On September 2, 1958, D still held the property which then had an adjusted basis in her hands of $65,000. Since the excess of the fair market value of the property at the time of the gift to D over the adjusted basis of the property in C's hands at such time is greater than the amount of gift tax paid, the basis of the property in D's hands would be increased as of September 2, 1958, by the amount of the gift tax paid, or $11,745. The adjusted basis of the property in D's hands, both for determining gain or loss on the sale of the property, would then be $76,745 ($65,000 plus $11,745).

Example (3). On December 31, 1951, E gave to his son, F, 500 shares of common stock of the X Corporation which shares had been purchased earlier by E at a cost of $100 per share, or a total cost of $50,000. The basis in E's hands was still $50,000 on the date of the gift to F. On the date of the gift, the fair market value of the 500 shares was $80,000 with respect to which E paid a gift tax in the amount of $10,695. In 1956, the 500 shares of X Corporation stock were exchanged for 500 shares of common stock of the Y Corporation in a reorganization with respect to which no gain or loss was recognized for income tax purposes under section 354. F still held the 500 shares of Y Corporation stock on September 2, 1958. Under such circumstances, the 500 shares of X Corporation stock would not, for purposes of section 1015(d) and this section, be considered as having been "sold, exchanged, or otherwise disposed of" by F before September 2, 1958. Therefore, the basis of the 500 shares of Y Corporation stock held by F as of such date would, by reason of section 1015(d) and this section, be increased by $10,695, the amount of gift tax paid with respect to the gift to F of the X Corporation stock.

Example (4). On November 15, 1953, G gave H property which had a fair market value of $53,000 and a basis in the hands of G of $20,000. G paid gift tax of $5,250 on the transfer. On November 16, 1956, H gave the property to J who still held it on September 2, 1958. The value of the property on the date of the gift to J was $63,000 and H paid gift tax of $7,125 on the transfer. Since the property was not sold, exchanged, or otherwise disposed of by J before September 2, 1958, and the gift tax paid on the transfer to J did not exceed $43,000 ($63,000, fair market value of property at time of gift to J, less $20,000, basis of property in H's hands at that time), the basis of property in his hands is increased on September 2, 1958, by $7,125, the amount of gift tax paid by H on the transfer. No increase in basis is allowed for the $5,250 gift tax paid by G on the transfer to H, since H had sold, exchanged, or otherwise disposed of the property before September 2, 1958.

(b) *Amount of gift tax paid with respect to a gift of property.* (1)(i) If only one gift was made during a certain calendar quarter (or calendar year if the gift was made before January 1, 1971), the entire amount of the gift tax paid under chapter 12 or the corresponding provisions of prior revenue laws for that calendar quarter (or calendar year) is the amount of the gift tax paid with respect to the gift.

(ii) If more than one gift was made during a certain calendar quarter (or calender year if the gifts were made before January 1, 1971), the amount of gift tax paid under chapter 12 or the corresponding provisions of prior revenue laws with respect to any specified gift made during that calendar quarter (or calendar year) is an amount, A, which bears the same ratio to B (the total gift tax paid for that calendar quarter or calendar year) as C (the "amount of the gift," computed as described in this subdivision) bears to D (the total taxable gifts for the calendar quarter or calendar year, computed without deduction for the gift tax specific exemption under section 2521 or the corresponding provisions of prior revenue laws). Stated algebraically, the amount of the gift tax paid with respect to a gift equals:

["Amount of the gift" (C)/ Total taxable gifts, plus specific exemption allowed (D)] × Total gift tax paid (B)

For purposes of the ratio stated in the preceding sentence, the "amount of the gift" referred to as factor "C" is the value of the gift reduced by any portion excluded or deducted under section 2503(b) (annual exclusion), 2522 (charitable deduction), or 2523 (marital deduction) of the Code or the corresponding provisions of prior revenue laws. In making the computations described in this paragraph, the values to be used are those finally determined for purposes of the gift tax.

(iii) If a gift consists of more than one item of property, the gift tax paid with respect to each item shall be computed by allocating to each item a proportionate part of the gift tax paid with respect to the gift, computed in accordance with the provisions of this paragraph.

(2) For purposes of this paragraph, it is immaterial whether the gift tax is paid by the donor or the donee. Where more than one gift of a present interest in property is made to the same donee during a calendar quarter or calendar year, the annual exclusion shall apply to the earliest of such gifts in point of time.

(3) Where the donor and his spouse elect under section 2513 or the corresponding provisions of prior law to have any gifts made by either of them considered as made one-half by each, the amount of gift tax paid with respect to such a gift is the sum of the amounts of tax (computed separately) paid with respect to each half of the gift by the donor and his spouse.

(4) The method described in section 1015(d)(2) and this paragraph for computing the amount of gift tax paid in respect of a gift may be illustrated by the following examples:

Example (1). Prior to 1959 H made no taxable gifts. On July 1, 1959, he made a gift to his wife, W, of land having a value for gift purposes of $60,000 and gave to his son, S, certain securities valued at $60,000. During the year 1959, H also contributed $5,000 in cash to a charitable organization described in section 2522. H filed a timely gift tax return for 1959 with respect to which he paid gift tax in the amount of $6,000, computed as follows:

Value of land given to W		$60,000	
Less: Annual exclusion	$3,000		
Marital deduction	30,000	33,000	
Included amount of gift			$27,000
Value of securities given to S		60,000	
Less: Annual exclusion		3,000	
Included amount of gift			57,000
Gift to charitable organization		5,000	
Less: Annual exclusion	3,000		
Charitable deduction	2,000	5,000	
Included amount of gift			0
Total included gifts			84,000
Less: Specific exemption allowed			30,000
Taxable gifts for 1959			54,000
Gift tax on $54,000			6,000

In determining the gift tax paid with respect to the land given to W, amount C of the ratio set forth in subparagraph (1)(ii) of this paragraph is $60,000, value of property given to W, less $33,000 (the sum of $3,000, the amount excluded under section 2503(b), and $30,000, the amount deducted under section 2523), or $27,000. Amount D of the ratio is $84,000 (the amount of taxable gifts, $54,000, plus the gift tax specific exemption, $30,000). The gift tax paid with respect to the land given to W is $1,928.57, computed as follows:

$27,000(C) ÷ $84,000(D) × $6,000(B)

Example (2). The facts are the same as in example (1) except that H made his gifts to W and S on July 1, 1971, and that prior to 1971, H made no taxable gifts. Furthermore, H made his charitable contribution on August 12, 1971. These were the only gifts made by H during 1971. H filed his gift tax return for the third quarter of 1971 on November 15, 1971, as required by section 6075(b). With respect to the above gifts H paid a gift tax in the amount of $6,000 on total taxable gifts of $54,000 for the third quarter of 1971. The gift tax paid with respect to the land given to W is $1,928.57. The computations for these figures are identical to those used in example (1).

Example (3). On January 15, 1956, A made a gift to his nephew, N, of land valued at $86,000, and on June 30, 1956, gave N securities valued at $40,000. On July 1, 1956, A gave to his sister, S, $46,000 in cash. A and his wife, B, were married during the entire calendar year 1956. The amount of A's taxable gifts for prior years was zero although in arriving at that amount A had used in full the specific exemption authorized by section 2521. B did not make any gifts before 1956. A and B elected under section 2513 to have all gifts made by either during 1956 treated as made one-half by A and one-half by B. Pursuant to that election, A and B each filed a gift tax return for 1956. A paid gift tax of $11,325 and B paid gift tax of $5,250, computed as follows:

	A	B
Value of land given to N	$43,000	$43,000
Less: exclusion	3,000	3,000
Included amount of gift	40,000	40,000
Value of securities given to N	20,000	20,000
Less: exclusion	None	None
Included amount of gift	20,000	20,000
Cash gift to S	23,000	23,000
Less: exclusion	3,000	3,000
Included amount of gift	20,000	20,000
Total included gifts	80,000	80,000
Less: specific exemption	None	30,000
Taxable gifts for 1956	80,000	50,000
Gift tax for 1956	11,325	5,250

The amount of the gift tax paid by A with respect to the land given to N is computed as follows:

$40,000(C)/$80,000(D) × $11,325(B) = $5,662.50

The amount of the gift tax paid by B with respect to the land given to N is computed as follows:

$40,000(C)/ $80,000(D) × $5,250(B) = $2,625

The amount of the gift tax paid with respect to the land is $5,662.50 plus $2,625, or $8,287.50. Computed in a similar manner, the amount of gift tax paid by A with respect to the securities given to N is $2,831.25, and the amount of gift tax paid by B with respect thereto is $1,312.50, or a total of $4,143.75.

Example (4). The facts are the same as in example (3) except that A gave the land to N on January 15, 1972, the securities to N on February 3, 1972, and the cash to S on March 7, 1972. As in example (3), the amount of A's taxable gifts for taxable years prior to 1972 was zero, although in arriving at that amount A had used in full the specific exemption authorized by section 2521. B did not make any gifts before 1972. Pursuant to the election under section 2513, A and B treated all gifts made by either during 1972 as made one-half by A and one-half by B. A and B each filed a gift tax return for the first quarter of 1972 on May 15, 1972, as required by section 6075(b). A paid gift tax of $11,325 on taxable gifts of $80,000 and B paid gift tax of $5,250 on taxable gifts of $50,000. The amount of the gift tax paid by A and B with respect to the land given to N is $5,662.50 and $2,625, respectively. The computations for these figures are identical to those used in example (3).

(c) *Treatment as adjustment to basis.* Any increase in basis under section 1015(d) and this section shall, for purposes of section 1016(b) (relating to adjustments to a substituted basis), be treated as an adjustment under section 1016(a) to the basis of the donee's property to which such increase applies. See paragraph (p) of § 1.1016-5.

[T.D. 6693, 28 FR 12818, Dec. 3, 1963, as amended by T.D. 7238, 37 FR 28715, Dec. 29, 1972]

§ 1.1016-1 Adjustments to basis; scope of section.

Section 1016 and §§ 1.1016-2 to 1.1016-10, inclusive, contain the rules relating to the adjustments to be made to the basis of property to determine the adjusted basis as defined in section 1011. However, if the property was acquired from a decedent before his death, see § 1.1014-6 for adjustments on account of certain deductions allowed the taxpayer for the period between the date of acquisition of the property and the date of death of the decedent. If an election has been made under the Retirement-Straight Line Adjustment Act of 1958 (26 U.S.C. 1016 note), see § 1.9001-1 for special rules for determining adjusted basis in the case of a taxpayer who has changed from the retirement to the straight-line method of computing depreciation allowances.

§ 1.1016-2 Items properly chargeable to capital account.

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. See the regulations under section 263(c).

(b) The application of the foregoing provisions may be illustrated by the following example:

Example. A, who makes his returns on the calendar year basis, purchased property in 1941 for $10,000. He subsequently expended $6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is $16,000. If A sells the property in 1954 for $20,000, the amount of his gain will be $4,000.

(c) Adjustments to basis shall be made for carrying charges such as taxes and interest, with respect to property (whether real or personal, improved or unimproved, and whether productive or unproductive), which the taxpayer elects to treat as chargeable to capital account under section 266, rather than as an allowable deduction. The term "taxes" for this purpose includes duties and excise taxes but does not include income taxes.

(d) Expenditures described in section 173 to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical are chargeable to capital account only in accordance with and in the manner provided in the regulations under section 173.

§ 1.1016-3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

(a) *In general*—(1) *Adjustment where deduction is claimed.* (i) For taxable periods beginning on or after January 1, 1952, the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of the following two amounts: (*a*) the amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or (*b*) the amount allowable for the years involved. See paragraph (b) of this section. Where the taxpayer makes an appropriate election the above rule is applicable for periods since February 28, 1913, and before January 1, 1952. See paragraph (d) of this section. For rule for such periods where no election is made, see paragraph (c) of this section.

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years shall not be increased even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement of depreciable property, including rules for determining basis, see § 1.167(a)-8. This subdivision may be illustrated by the following example:

Example. An asset was purchased January 1, 1950, at a cost of $10,000. The useful life of the asset is 10 years. It has no salvage value. Depreciation was deducted and allowed for 1950 to 1954 as follows:

1950	$500
1951	
1952	1,000
1953	1,000
1954	1,000
Total amount allowed	3,500

The correct reserve as of December 31, 1954, is computed as follows:

Dec. 31:	
1950 ($10,000÷10)	$1,000
1951 ($9,000÷9)	1,000
1952 ($8,000÷8)	1,000
1953 ($7,000÷7)	1,000
1954 ($6,000÷6)	1,000
Reserve Dec. 31, 1954	5,000
Depreciation for 1955 is computed as follows:	
Cost	10,000
Reserve as of December 31, 1954	5,000
Unrecovered cost	5,000
Depreciation allowable for 1955 ($5,000÷5)	1,000

(2) *Adjustment for amount allowable where no depreciation deduction claimed.* (i) If the taxpayer has not taken a depreciation deduction either in the taxable year or for any prior taxable year, adjustments to basis of the property for depreciation allowable shall be determined by using the straight-line method of depreciation. (See § 1.1016-4 for adjustments in the case of persons exempt from income taxation.)

(ii) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, if the taxpayer with respect to any property has taken a deduction for depreciation properly under one of the methods provided in section 167(b) for one or more years but has omitted the deduction in other years, the adjustment to basis for the depreciation allowable in such a case will be the deduction under the method which was used by the taxpayer with respect to that property. Thus, if A acquired property in 1954 on which he properly computed his depreciation deduction under the method described in section 167(b)(2) (the declining-balance method) for the first year of its useful life but did not take a deduction in the second and third year of the asset's life, the adjustment to basis for depreciation allowable for the second and third year will be likewise computed under the declining-balance method.

(3) *Adjustment for depletion deductions with respect to taxable years before 1932.* Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall not exceed a depletion deduction which would have been allowable for such year if computed without reference to discovery value or a percentage of income.

(b) *Adjustment for periods beginning on or after January 1, 1952.* The decrease required by paragraph (a) of this section for deductions in respect of any period beginning on or after January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing taxable income under subtitle A of the Code or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income) or prior income, war-profits, or excess-profits tax laws; or

(2) The amount properly allowable as deductions in computing taxable income under subtitle A of the Code or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(c) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where no election made.* If no election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939 (see paragraph (d) of this section), the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever of the following amounts is the greater:

(1) The amount allowed as deductions in computing net income under

chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws;

(2) The amount properly allowable in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws.

For the purpose of determining the decrease required by this paragraph, it is immaterial whether or not the amount under subparagraph (1) of this paragraph or the amount under subparagraph (2) of this paragraph would have resulted in a reduction for any taxable year of the taxpayer's taxes.

(d) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where election made.* If an election has been properly made under section 1020, or under section 113(d) of the Internal Revenue Code of 1939, the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under such chapter 1 (other than subchapter E, relating to tax on self-employment income), subchapter E, chapter 2, of the Internal Revenue Code of 1939, or prior income, war-profits, or excess-profits tax laws;

(2) The amount properly allowable as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(e) *Determination of amount allowed which reduced taxpayer's taxes.* (1) As indicated in paragraphs (b) and (d) of this section, there are situations in which it is necessary to determine (for the purpose of ascertaining the basis adjustment required by paragraph (a) of this section) the extent to which the amount allowed as deductions resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws. This amount (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the "tax-benefit amount allowed." For the purpose of determining whether the tax-benefit amount allowed exceeded the amount allowable, a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable. In such a case (if paragraph (b) or (d) of this section is applicable) the reduction in basis required by paragraph (a) of this section would be the amount properly allowable as a deduction. If only part of such excess could be disallowed without any such increase in tax, the tax-benefit amount allowed shall be considered to exceed the amount allowable to the extent of the remainder of such excess. In such a case (if paragraph (b) or (d) of this section is applicable), the reduction in basis required by paragraph (a) of this section would be the amount of the tax-benefit amount allowed.

(2) For the purpose of determining the tax-benefit amount allowed the tax previously determined shall be determined under the principles of section 1314. The only adjustments made in determining whether there would be an increase in tax shall be those resulting from the disallowance of the amount allowed. The taxable years for which the determination is made shall be the taxable year for which the deduction was allowed and any other taxable year which would be affected by the disallowance of such deduction. Examples of such other taxable years are taxable years to which there was a carryover or carryback of a net operating loss from the taxable year for which the deduction was allowed, and taxable years for which a computation

under section 111 or section 1333 was made by reference to the taxable year for which the deduction was allowed. In determining whether the disallowance of any part of the deduction would not have resulted in an increase in any tax previously determined, proper adjustment must be made for previous determinations under section 1311, or section 3801 of the Internal Revenue Code of 1939, and for any previous application of section 1016(a)(2)(B), or section 113(b)(1)(B)(ii) of the Internal Revenue Code of 1939.

(3) If a determination under section 1016(a)(2)(B) must be made with respect to several properties for each of which the amount allowed for the taxable year exceeded the amount allowable, the tax-benefit amount allowed with respect to each of such properties shall be an allocated portion of the tax-benefit amount allowed determined by reference to the sum of the amounts allowed and the sum of the amounts allowable with respect to such several properties.

(4) In the case of property held by a partnership or trust, the computation of the tax-benefit amount allowed shall take into account the tax benefit of the partners or beneficiaries, as the case may be, from the deduction by the partnership or trust of the amount allowed to the partnership or the trust. For this purpose, the determination of the amount allowed which resulted in a tax benefit to the partners or beneficiaries shall be made in the same manner as that provided above with respect to the taxes of the person holding the property.

(5) A taxpayer seeking to limit the adjustment to basis to the tax-benefit amount allowed for any period, in lieu of the amount allowed, must establish the tax-benefit amount allowed. A failure of adequate proof as to the tax-benefit amount allowed with respect to one period does not preclude the taxpayer from limiting the adjustment to basis to the tax-benefit amount allowed with respect to another period for which adequate proof is available. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction of erroneous depreciation for certain taxable years, but may not have available adequate records with respect to the deduction of excessive depreciation for other taxable years during which the property was held by its transferor. In such case the corporate transferee shall not be denied the right to apply this section with respect to the erroneous depreciation for the period for which adequate proof is available.

(f) *Determination of amount allowable in prior taxable years.* (1) One of the factors in determining the adjustment to basis as of any date is the amount of depreciation, depletion, etc., allowable for periods prior to such date. The amount allowable for such prior periods is determined under the law applicable to such prior periods; all adjustments required by the law applicable to such periods are made in determining the adjusted basis of the property for the purpose of determining the amount allowable. Provisions corresponding to the rules in section 1016(a)(2)(B) described in paragraphs (d) and (e) of this section, which limit adjustments to the "tax-benefit amount allowed" where an election is properly exercised, were first enacted by the Act of July 14, 1952 (66 Stat. 629). That law provided that corresponding rules are deemed to be includible in all revenue laws applicable to taxable years ending after December 31, 1931. Accordingly, those rules shall be taken into account in determining the amount of depreciation, etc., allowable for any taxable year ending after December 31, 1931. For example, if the adjusted basis of property held by the taxpayer since January 1, 1930, is determined as of January 1, 1955, and if an election was properly made under section 1020, or section 113(d) of the Internal Revenue Code of 1939, then the amount allowable which is taken into account in computing the adjusted basis as of January 1, 1955, shall be determined by taking those rules into account for all taxable years ending after December 31, 1931. The Act of July 14, 1952, made no change in the law applicable in determining the amount allowable for taxable years ending before January 1, 1932. If there was a final decision of a court prior to the enactment of the Act of July 14, 1952, determining the amount allowable for a particular taxable year, such determination shall be adjusted. In such case the adjustment shall be made only for the purpose of taking the provision of that law into account and only to the extent made necessary by such provisions.

(2) Although the Act of July 14, 1952, amended the law applicable to all taxable years ending after December 31, 1931, the amendment does not permit refund, credit, or assessment of a deficiency for any taxable year for which such refund, credit, or assessment was barred by any law or rule of law.

(g) *Property with transferred basis.* The following rules apply in the determination of the adjustments to basis of property in the hands of a transferee, donee, or grantee which are required by section 1016(b), or section 113(b)(2) of the Internal Revenue Code of 1939, with respect to the period the property was held by the transferor, donor, or grantor:

(1) An election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, by a transferor, donor, or grantor, which is made after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. An election or a revocation of an election made before the date of the transfer, gift, or grant of the property shall be taken into account in determining under section 1016(b) the adjustments to basis of such property as of the date of the transfer, gift, or grant, whether or not an election or a revocation of an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939, was made by the transferee, donee, or grantee.

(2) An election by the transferee, donee, or grantee or a revocation of such an election shall be applicable in determining the adjustments to basis for the period during which the property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor had made an election or a revocation of an election, provided that the property was held by the transferee, donee, or grantee at any time on or before the date on which the election or revocation was made.

(h) *Examples.* The application of section 1016(a)(1) and (2) may be illustrated by the following examples:

Example (1). The case of Corporation A discloses the following facts:

The cost or other basis is to be adjusted by $16,500 with respect to the years 1952-54, that is, by the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes. An adjustment must also be made with respect to the years 1949-1951, the amount of such adjustment depending upon whether an election was properly made under section 1020, or section 113(d) of the Internal Revenue Code of 1939. If no such election was made, the amount of the adjustment with respect to the years 1949-51 is $19,500, that is, the amount allowed but not less than the amount allowable. If an election was properly made, the amount of the adjustment with respect to the years 1949-51 is $19,000, that is, the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes.

(1)—Year	(2)—Amount allowed	(3)—Amount allowed which reduced taxpayer's taxes	(4)—Amount allowable	(5)—Amount allowable but not less than amount allowed	(6)—Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1949	$6,000	$5,500	$5,000	$6,000	$5,500
1950	7,000	7,000	6,500	7,000	7,000
1951	5,000	4,000	6,500	6,500	6,500
Total, 1949-51				19,500	19,000
1952	6,500	6,500	6,000		6,500
1953	5,000	4,000	4,000		4,000
1954	4,500	4,500	6,000		6,000
Total, 1952-54					16,500

Example (2). Corporation A, which files its returns on the basis of a calendar year, purchased a building on January 1, 1950, at a cost of $100,000. On the basis of the facts reasonably known to exist at the end of 1950, a period of 50 years should have been used as the correct useful life of the building; nevertheless, depreciation was computed by Corporation A on the basis of a useful life of 25 years, and was allowed for 1950 through 1953 as a deduction in an annual amount of $4,000. The building was sold on January 1, 1954. Corporation A did not make an election under section 1020, or section 113(d) of the Internal Revenue Code of 1939. No part of the amount allowed Corporation A for any of the years 1950 through 1953 resulted in a reduction of Corporation A's taxes. The adjusted basis of the building as of January 1, 1954, is $88,166, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	8,000	92,000	48	1,917	4,000
1953	9,917	90,083	47	1,917	4,000
1954	11,834	88,166			

Example (3). The facts are the same as in example (2), except that Corporation A made a proper election under section 1020. In such case, the adjusted basis of the building as of January 1, 1954, is $92,000 computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$2,000	98,000	49	2,000	4,000
1952	4,000	96,000	48	2,000	4,000
1953	6,000	94,000	47	2,000	4,000
1954	8,000	92,000			

Example (4). If it is assumed that in example (2), or in example (3), all of the deduction allowed Corporation A for 1953 had resulted in a reduction of A's taxes, the adjustment to the basis of the building for depreciation for 1953 would reflect the entire $4,000 deduction. In such case, the adjusted basis of the building as of January 1, 1954, would be $86,083 in example (2), and $90,000 in example (3).

Example (5). The facts are the same as in example (2), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation for that year resulted in a reduction of A's taxes. In such case, the adjustments to the basis of the building remain the same as those set forth in example (2).

Example (6). The facts are the same as in example (3), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation resulted in a reduction of A's taxes. In such case, the adjusted basis of the building as of January 1, 1954, is $90,123, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	5,959	94,041	48	1,959	4,000
1953	7,918	92,082	47	1,959	4,000
1954	9,877	90,123			

§ 1.1016–4 Exhaustion, wear and tear, obsolescence, amortization, and depletion; periods during which income was not subject to tax.

(a) Adjustments to basis must be made for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent actually sustained in respect of:

(1) Any period before March 1, 1913,

(2) Any period since February 28, 1913, during which the property was held by a person or organization not subject to income taxation under chapter 1 of the Code or prior income tax laws,

(3) Any period since February 28, 1913, and before January 1, 1958, during which the property was held by a person subject to tax under part I, subchapter L, chapter 1 of the Code, or prior income tax law, to the extent that section 1016(a)(2) does not apply, and

(4) Any period since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L, chapter 1 of the Code, or prior income tax law, to the extent that section 1016(a)(2) does not apply.

(b) The amount of the adjustments described in paragraph (a) of this section actually sustained is that amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable. Otherwise, the amount actually sustained will be the amount that would have been allowable as a deduction:

(1) During the period described in paragraph (a)(1) or (2) of this section, had the taxpayer been subject to income tax during those periods, or

(2) During the period described in paragraph (a)(3) or (4) of this section, with respect to property held by a taxpayer described in that paragraph, to the extent that section 1016(a)(2) was inapplicable to such property during that period.

In the case of a taxpayer subject to the adjustment required by subparagraph (1) or (2) of this paragraph, depreciation shall be determined by using the straight line method.

[T.D. 6681, 28 FR 11131, Oct. 17, 1963]

§ 1.1016–5 Miscellaneous adjustments to basis.

(a) *Certain stock distributions.* (1) In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057) or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or the Revenue Act of 1921). For adjustments to basis in the case of certain corporate distributions, see section 301 and the regulations thereunder.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated before March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1954 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition.

(b) *Amortizable bond premium.* In the case of a tax-exempt bond, basis shall be reduced by the amount of the amortizable bond premium disallowable as a deduction under section 171(a)(2), or under section 125(a)(2) of the Internal Revenue Code of 1939 and, in the case of any other bond (as defined in section 171(d)), basis shall be reduced by the amount of the deductions allowable under section 171(a)(1), or under section 125(a)(1) of the Internal Revenue Code of 1939.

(c) *Municipal bonds.* In the case of a municipal bond (as defined in section 75(b)), basis shall be adjusted to the extent provided in section 75 or as provided in section 22(o) of the Internal Revenue Code of 1939, and the regulations thereunder.

(d) *Sale or exchange of residence.* Where the acquisition of a new residence results in the nonrecognition of any part of the gain on the sale, or exchange, or involuntary conversion of the old residence, the basis of the new residence shall be reduced by the amount of the gain not so recognized pursuant to section 1034(a), or section 112(n) of the Internal Revenue Code of 1939, and the regulations thereunder. See section 1034(e) and the regulations thereunder.

(e) *Loans from Commodity Credit Corporation.* In the case of property pledged to the Commodity Credit Corporation, the basis of such property shall be increased by the amount received as a loan from such corporation and treated by the taxpayer as income for the year in which received under section 77, or under section 123 of the Internal Revenue Code of 1939. The basis of such property shall be reduced to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.

(f) *Deferred development and exploration expenses.* Expenditures for development and exploration of mines or mineral deposits treated as deferred expenses under sections 615 and 616, or under the corresponding provisions of prior income tax laws, are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016-3. For example, if a taxpayer purchases unexplored and undeveloped mining property for $1,000,000 and at the close of the development stage has incurred exploration and development costs of $9,000,000 treated as deferred expenses, the basis of such property at such time for computing gain or loss will be $10,000,000. Assuming that the taxpayer in this example has operated the mine for several years and has deducted allowable percentage depletion in the amount of $2,000,000 and has deducted allowable deferred exploration and development expenditures of $2,000,000, the basis of the property in the taxpayer's hands for purposes of determining gain or loss from a sale will be $6,000,000.

(g) *Sale of land with unharvested crop.* In the case of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231, the basis of such crop shall be increased by the amount of the items which are attributable to the production of such crop and which are disallowed, under section 268, as deductions in computing taxable income. The basis of any other property shall be decreased by the amount of any such items which are attributable to such other property, notwithstanding any provisions of section 1016 or of this section to the contrary. For example, if the items attributable to the production of an unharvested crop consist only of fertilizer costing $100 and $50 depreciation on a tractor used only to cultivate such crop, and such items are disallowed under section 268, the adjustments to the basis of such crop shall include an increase of $150 for such items and the adjustments to the basis of the tractor shall incude a reduction of $50 for depreciation.

(h) *Consent dividends.* (1) In the case of amounts specified in a shareholder's consent to which section 28 of the Internal Revenue Code of 1939 applies, the basis of the consent stock shall be increased to the extent provided in subsection (h) of such section.

(2) In the case of amounts specified in a shareholder's consent to be treated as a consent dividend to which section 565 applies, the basis of the consent stock shall be increased by the amount which, under section 565(c)(2), is treated as contributed to the capital of the corporation.

(i) *Stock in foreign personal holding company.* In the case of the stock of a United States shareholder in a foreign personal holding company, basis shall be adjusted to the extent provided in section 551(f) or corresponding provisions of prior income tax laws.

(j) *Research and experimental expenditures.* Research and experimental expenditures treated as deferred expenses under section 174(b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016-3.

(k) *Deductions disallowed in connection with disposal of coal or domestic iron ore.* Basis shall be adjusted by the amount of the deductions disallowed under section 272 with respect to the disposal of coal or domestic iron ore covered by section 631.

(l) *Expenditures attributable to grants or loans covered by section 621.* In the case of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, basis shall be adjusted to the extent provided in section 621, or in section 22(b)(15) of the Internal Revenue Code of 1939.

(m) *Trademark and trade name expenditures.* Trademark and trade name expenditures treated as deferred expenses under section 177 are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2, relating to tax on self-employment income) of the Code, but not less than the amounts allowable under such section for the taxable year and prior years. This amount is considered as the "tax- benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016-3.

(n) *Life insurance companies.* In the case of any evidence of indebtedness referred to in section 818(b), the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years. The basis of any such evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(o) *Stock and indebtedness of electing small business corporation.* In the case of a shareholder of an electing small business corporation, as defined in section 1371(b), the basis of the shareholder's stock in such corporation, and the basis of any indebtedness of such corporation owing to the shareholder, shall be adjusted to the extent provided in §§ 1.1375-4, 1.1376-1, and 1.1376-2.

(p) *Gift tax paid on certain property acquired by gift.* Basis shall be adjusted by that amount of the gift tax paid in respect of property acquired by gift which, under section 1015(d), is an increase in the basis of such property.

(q) *Section 38 property.* In the case of property which is or has been section 38 property (as defined in section 48(a)), the basis shall be adjusted to the extent provided in section 48(g) and in section 203(a)(2) of the Revenue Act of 1964.

(r) *Stock in controlled foreign corporations and other property.* In the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock, the basis shall be adjusted to the extent provided in section 961.

(s) *Original issue discount.* In the case of certain corporate obligations issued at a discount after May 27, 1969, the basis shall be increased under section 1232(a)(3)(E) by the amount of original issue discount included in the holder's gross income pursuant to section 1232(a)(3).

(t) *Section 44C credit.* In the case of property with respect to which a credit has been allowed under section 44C (relating to residential energy credit), basis shall be adjusted as provided in paragraph (k) of § 1.44C-3.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6610, 27 FR 8724, Aug. 31, 1962; T.D. 6647, 28 FR 3522, Apr. 11, 1963; 28 FR 3721, Apr. 17, 1963; T.D. 6693, 28 FR 12819, Dec. 3, 1963; T.D. 6795, 30 FR 948, Jan. 29, 1965; T.D. 6841, 30 FR 9309, July 27, 1965; T.D. 7154, 36 FR 24998, Dec. 28, 1971; T.D. 7717, 45 FR 57722, Aug. 29, 1980]

§ 1.1016-6 Other applicable rules.

(a) Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(b) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Code, and prior internal revenue laws.

§ 1.1016-7 Adjusted basis; cancellation of indebtedness under Bankruptcy Act.

(a) In addition to the adjustments provided in section 1016, further adjustment is required in the case of a cancellation or deduction of indebtedness in any proceeding under chapters X, XI, or XII of the Bankruptcy Act (11 U.S.C. ch. 10, 11, and 12) and corresponding provisions of prior law. For exceptions to the above rule see sections 372, 373, 374, and 1018. Furthermore, no such further adjustment will be made in the case of a "wage earner" as that term is defined in section 606(8) of the Bankruptcy Act (11 U.S.C. 1006 (8). The further adjustments required by this section shall be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any such proceeding, the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(3) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced in such proceeding over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by such subparagraphs) as follows: the cost or other basis of each unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis (after adjustment under subparagraphs (1) and (2) of this paragraph) of each such unit of property bears to the sum of the adjusted bases (after adjustment under such subparagraphs) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments made under subparagraphs (1), (2), and (3), of this paragraph shall next be applied to reduce the cost or other basis of any units of property covered by such subparagraphs which have a remaining basis (after adjustment under such subparagraphs) greater than their fair market value, as follows: the cost or other basis of each such unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the remaining basis of each such unit bears to the sum of the remaining basis of such units. The process shall be repeated until the cost or other basis of each unit of the property covered by subparagraphs (1), (2), and (3) of this paragraph is reduced to its fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value; and

(5) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced over the sum of the adjustments made under subparagraphs (1), (2), (3), and (4) of this paragraph shall next be applied to reduce the cost or other basis of inventory and notes and accounts receiv-

able as follows: the cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable. The process shall be repeated until the adjusted bases of inventory, notes receivable, and accounts receivable are reduced to their fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value.

(b) For the purposes of this section:

(1) Basis shall be determined as of the dates of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced;

(2) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(3) No adjustment shall be made by virtue of the cancellation or reduction of any accured interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(4) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(5) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced.

(c) Any determination of value in a proceeding under the Bankruptcy Act (11 U.S.C. 1 et seq.), shall not constitute a determination of fair market value for the purpose of this section.

(d) The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this section.

§ 1.1016-8 Adjusted basis; cancellation of indebtedness; special cases.

If the taxpayer and the Commissioner agree, the basis of the taxpayer's property may be adjusted in a manner different from that set forth in § 1.1016-7. Variations from such rule may, for example involve adjusting the basis of any part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation. Agreement between the taxpayer and the Commissioner as to any variation from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

§ 1.1016-9 Adjusted basis; mutual savings banks, building and loan associations, and cooperative banks.

(a) The adjustments to the cost or other basis of property provided in section 1016 and §§ 1.1016-1 to 1.1016-8, inclusive, are applicable in the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, although such institutions were exempt from tax for taxable years beginning before January 1, 1952. Proper adjustment must be made under section 1016 for the entire period since the acquisition of property. Thus, adjustment to basis must be made for depreciation sustained for all prior taxable years although such institution may have been exempt from tax during such years. Similarly, in the case of tax-exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond (or in the case of bonds not issued with interest coupons, or in registered form, from the date such bonds are subject to amortization under section 171).

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. On January 1, 1954, Z, a mutual savings bank, which keeps its books on a calendar year basis, owns a tax-exempt $1,000 noncallable bond maturing on January 1, 1964. Such bond was acquired by Z on January 1, 1934, for $1,300. It was sold by Z on December 31, 1954, for $1,250. The yearly rate of amortization of the premium, determined by dividing the total premium of $300 by the life of the bond (30 years) is $10. Z realizes a gain of $80 from such sale computed as follows:

(1) Cost of bond		$1,300
(2) Amount of bond premium attributable to years 1942 through 1951, during which Z was exempt from tax ($10 times 10 years)	$100	
(3) Amount of bond premium amortized from Jan. 1, 1952, through Dec. 31, 1954 ($10 times 3 years)	30	
(4) Total amount of adjustments to basis (aggregate of (2) and (3))		
(5) Adjusted basis of bond at close of 1954 ((1) reduced by (4))		1,170
(6) Gain realized upon sale—excess of sale price over adjusted basis ($1,250 minus $1,170)		80

The basis of a fully taxable bond purchased at a premium shall be adjusted from the date to which the election applies to amortize such premium in accordance with the provisions of section 171, except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(c) In the case of a mortgage (not within the definition of section 171(d)) purchased, acquired, or originated at a premium, where the principal of such mortgage is payable in installments, adjustments to the basis of the premium must be made for all taxable years (whether or not the institution was exempt from tax during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such institution. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees, or brokerage fees, but such value does not include amounts paid for accrued interest. For the method of amortization in the case of corporate mortgages purchased, acquired, or originated at a premium, see paragraph (e) of § 1.171-2.

§ 1.1016–10 Substituted basis.

(a) Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b), the adjustments indicated in §§ 1.1016-1 to 1.1016-6, inclusive, shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016(b)(1), the adjustments indicated in §§ 1.1016-7 to 1.1016-9, inclusive, and in section 1017 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

(b) The application of this section may be illustrated by the following example:

Example. A, who makes his returns upon the calendar year basis, in 1935 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or disposition of the Y Building in 1954, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

§ 1.1017–1 Adjusted basis; discharge of indebtedness; general rule.

(a) In addition to the adjustments provided in section 1016 and the regulations thereunder which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 372(a), 373(b)(2), or 1018, a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 108(a) on account of a discharge of indebtedness during the taxable year. Such further adjustments shall, except as otherwise provided in § 1.1017-2, be made in the following manner and order (but in the case of an individual, subparagraphs (1) to (4), inclusive, of this paragraph, shall apply only to property used in any trade or business of such individual):

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been discharged, the cost or other basis of such property shall be decreased by an amount equal to the amount excluded from gross income under section 108(a) and attributable to the discharage of the indebtedness so incurred with respect to such property;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the discharge of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property), the cost or other basis of such property shall be decreased by an amount equal to the amount excluded from gross income under section 108(a) and attributable to the discharge of the indebtedness secured by such lien;

(3) Any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph shall next be applied to reduce the cost or other basis of all the property of the debtor (other than inventory and notes and accounts receivable) as follows: The cost or other basis of each unit of property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of adjusted bases (without reference to this section) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1), (2), and (3) of this paragraph shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable;

(5) In the case of an individual, any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1), (2), (3), and (4) of this paragraph shall next be applied to reduce the cost or other basis of his property held for the production of income, as follows: The cost or other basis of each unit of such property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of the adjusted bases (without reference to this section) of all of such property of the debtor; and

(6) In the case of an individual, any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1), (2), (3), (4), and (5) of this paragraph shall next be applied to reduce the cost or other basis of his property other than property used in any trade or business and property held for the production of income, as follows: The cost or other basis of each unit of such property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to

the sum of the adjusted bases (without reference to this section) of all of such property of the debtor.

In the application of subparagraphs (1), (2), (3), (4), (5) and (6) of this paragraph, no decrease in the cost or other basis of any property shall exceed the amount of adjusted basis of such property without reference to this section.

(b) For the purposes of this section:

(1) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(2) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay;

(3) The phrase "amount excluded from gross income under section 108(a)" means the amount of income excluded under that section reduced by any deduction disallowed under that section for unamortized discount;

(4) Adjustments to basis shall be made:

(i) In the case of property owned on the first day of the taxable year, as of that day;

(ii) In the case of property acquired after the first day of the taxable year, as of the day so acquired—regardless of the time such property was subsequently sold, exchanged, or otherwise disposed of by the taxpayer;

(5) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;

(6) Regardless of the amount excluded by the taxpayer from his gross income under section 108(a) and so stated on Form 982, the maximum amount by which basis may be reduced in respect of the discharge of any indebtedness is the amount of income resulting from the discharge of such indebtedness; and

(7) Any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 108(a)) after the application of paragraph (a)(1) of this section shall be applied first against property of a character subject to the allowance for depreciation under section 167, property with respect to which a deduction for amortization is allowable under section 168 or 169, and property with respect to which a deduction for depletion is allowable under section 611 (but not including property specified in section 613), in the order in which such property is described in paragraph (a) (2) and (3) of this section. This section shall not be applicable to property with respect to which basis is reduced under paragraph (a) (5) and (6) of this section. Any further adjustment in basis required to be made under section 108(a) shall be applied against other property in the order prescribed in paragraph (a)(2), (3), (4), (5), and (6) of this section.

(c) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). On January 1, 1954, the N Corporation owned an office building, which it sold in March 1954. In June 1954 it purchased a factory building. In October 1954 the N Corporation bought in its outstanding bonds at less than their face value. Assuming that there is a proper exclusion from gross income under section 108(a), the basis of each building shall be adjusted under section 1017 for the taxable year 1954. (But see § 1.1017-2.)

Example (2). The M Corporation had outstanding an issue of A bonds which it had sold at a premium and an issue of B bonds which it had sold at a discount. In July 1954 the M Corporation purchased such outstanding bonds for less than face value. The amount of income attributable to the discharge of the A bonds is $1,000 and the amount of unamortized premium (as of the first day of the taxable year in which the discharge occurred) is $200. The amount of income attributable to the discharge of the B bonds is $1,000 and the amount of unamortized discount (as of the first day of the taxable year in which the discharge occurred) is $50. Each issue of bonds is regarded as a separate indebtedness and the M Corporation may elect under section 108(a) with respect to each issue or both issues. If the M Corporation elects under section 108(a) to have excluded from gross income the amount of income attributable to the discharge of the issue of A bonds, the total reduction in basis of property of the M Corporation shall not exceed $1,200. If the M

Corporation elects with respect to the B bonds, the total reduction in basis shall not exceed $950. If the M Corporation elects with respect to both bond issues, the total reduction in basis shall not exceed $2,150.

§ 1.1017-2 Adjusted basis; discharge of indebtedness; special cases.

(a) Section 1.1017-1 prescribes the general rule to be followed in adjusting basis of property where there is a proper exclusion from gross income under section 108(a). The taxpayer may, however, have the basis of his property adjusted in a manner different from that set forth in § 1.1017-1 upon a proper showing to the satisfaction of the Commissioner. Such adjustment, however, shall be consistent with the principles of § 1.1017-1. Variations from such general rule may, for example, involve adjusting the basis of only part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation.

(b) A request for variations from the general rule prescribed in § 1.1017-1 shall be filed by the taxpayer with his return for the taxable year in which the discharge of indebtedness occurred unless a consent is permitted (under § 1.108 (a)-(2) after the original return has been filed, in which case such request shall be filed with the amended return or claim for credit or refund, as the case may be. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule prescribed in § 1.1017-1, then the consent filed on Form 982 shall be deemed to be a consent to the application of such general rule and such general rule shall prevail in the determination of the basis of the taxpayer's property. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule and the taxpayer specifically states that he does not consent to the application of the general rule, then section 108(a) and section 1017 shall not apply.

§ 1.1018-1 Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.

The adjustment to basis provided by section 270 of the Bankruptcy Act, as amended (11 U.S.C. 670), and by §§ 1.1016-7 and 1.1016-8 shall not be made if, in a proceeding under section 77B of such Act, as amended (11 U.S.C. 207; 48 Stat. 912), indebtedness was canceled in pursuance of a plan of reorganization which was consummated by adjustment of the capital or debt structure of the insolvent corporation, and the final judgment or decree in such proceeding was entered before September 22, 1938. Section 1018 and this section do not apply if the plan of reorganization under such section 77B was consummated by the transfer of assets of the insolvent corporation to another corporation.

§ 1.1019-1 Property on which lessee has made improvements.

In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 109, would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of $50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth $75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code.

§ 1.1020-1 Election as to amounts allowed in respect of depreciation, etc., before 1952.

(a) *In general.* (1) Any person may elect to have the adjustments to the cost or other basis of property under section 1016(a)(2) determined in accordance with subparagraph (B) of such section by filing a statement of election in accordance with the requirements set forth in paragraph (b) of this section. Any election made after 1952 shall be irrevocable when made. Any election made after 1952 shall apply with respect to all property held by the person making the election at any time on or before December 31, 1952, and shall apply to all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016(b). For rules with respect to an election made on or before December 31, 1952, see paragraph (c) of this section.

(2) An election by a partner on his own behalf is not an election for the partnership of which he is a member. A separate election must be made on behalf of the partnership. (See section 703(b) (relating to elections of the partnership).) An election on behalf of the partnership applies only with respect to the partnership, and does not apply to the separate property of the partners. A similar rule applies with respect to elections by trusts and beneficiaries of trusts. These rules also apply with respect to a revocation of an election where such election was made on or before December 31, 1952.

(b) *Rules applicable to making of election.* The following rules are applicable to the making of an election under section 1020:

(1) *Form of election.* The election shall be in the form of a statement in writing, shall state the name and address of the taxpayer making the election, and shall contain a statement that such taxpayer elects to have the provisions of section 1016(a)(2)(B) apply in respect of all periods since February 28, 1913, and before January 1, 1952.

(2) *Signature.* The statement shall be signed by the taxpayer making the election, if an individual, or, if the taxpayer making the election is not an individual, the statement shall be signed by the person or persons required to sign the income return of such taxpayer.

(3) *Filing.* The statement must be filed on or before December 31, 1954, in the office of the district director for the internal revenue district in which the income tax return for the year of the election is required to be filed. For rules as to when timely mailing will be treated as timely filing of the statement see section 7502.

(4) *Filing of duplicate.* A copy of the statement of election must be filed with the first return, amended return, or claim for refund filed on or after the date on which the election is made.

(c) *Election made on or before December 31, 1952.* An election made on or before December 31, 1952, in accordance with the provisions of section 113(d) of the Internal Revenue Code of 1939, may be revoked by filing on or before December 31, 1954, in the same office in which the election was filed, a statement of revocation signed in the same manner as the election. Such statement made by any person is irrevocable when made with respect to such person, and no new election may thereafter be made by such person. A copy of the revocation must be filed with the first return, amended return, or claim for refund, filed after the date of the revocation. For additional rules with respect to election made on or before December 31, 1952, see 26 CFR (1939) 39.113(b)(1)-1 (Regulations 118).

(d) *Validity of elections or revocation of elections.* An election or revocation of an election which conforms in substance to the provisions of this section will not be deemed invalid solely because it was filed before the date on which the regulations in this section were promulgated.

(e) *Effect of election.* For rules relating to the effect of an election under this section, see section 1016(a)(2) and the regulations thereunder.

§ 1.1021-1 Sale of annuities.

In the case of a transfer for value of an annuity contract to which section 72(g) and paragraph (a) of § 1.72-10 apply, the transferor shall adjust his basis in such contract as of the time immediately prior to such transfer by subtracting from the premiums or other consideration he has paid or is deemed to have paid for such contract all amounts he has received or is deemed to have received under such annuity contract to the extent that such amounts were not includible in the gross income of the transferor or other recipient under the applicable income tax law. In any case where the amounts which were not includible in the gross income of the recipient were received or deemed to have been received by such transferor exceed the amounts paid or deemed paid by him, the adjusted basis of the contract shall be zero. The income realized by the transferor on such a transfer shall not exceed the total of the amounts received as consideration for the transfer.

COMMON NONTAXABLE EXCHANGES

§ 1.1031(a)-1 Property held for productive use in trade or business or for investment.

(a) Section 1031(a) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. See section 1002 and the regulations thereunder. Under section 1031(a), no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment. Under section 1031(a), property held for productive use in trade or business may be exchanged for property held for investment. Similarly, property held for investment may be exchanged for property held for productive use in trade or business. However, section 1031(a) provides that property held for productive use in trade or business or for investment does not include stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest. A transfer is not within the provisions of section 1031(a) if as part of the consideration the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b). Similarly, a transfer is not within the provisions of section 1031(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(b) As used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

(c) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or (2) a real estate mortgage for consolidated farm loan bonds.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17. 1967]

§ 1.1031(b)-1 Receipt of other property or money in tax-free exchange.

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money—

(1) In an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment,

(2) In an exchange described in section 1035(a) of insurance policies or annuity contracts,

(3) In an exchange described in section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, or

(4) In an exchange described in section 1037(a) of obligations of the United States, issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), solely for other obligations issued under such Act, the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to the taxpayer from such an exchange will not be recognized under section 1031(c) to any extent.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

Example (2). (a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for $750 each, B purchased four $1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

(b) On October 1, 1963, the redemption value of each such bond was $1,396, and the total redemption value of the four bonds was $5,584. On that date B submitted the four $1,000 series E bonds to the United States in a transaction in which one of such $1,000 bonds was reissued by issuing four $100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such $100 series E bond was $139.60 on October 1, 1963. Then, as part of the transaction, the six $100 series E bonds so considered to have been issued and the three $1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five $1,000 series H U.S. savings bonds plus $25.60 in cash.

(c) The gain realized on the exchange qualifying under section 1037(a) is $2,325.60, determined as follows:

Amount realized:		
Par value of five series H bonds		$5,000.00
Cash received		25.60
Total realized		5,025.60
Less: Adjusted basis of series E bonds surrendered in the exchange:		
Three $1,000 series E bonds	$2,250.00	
Six $100 series E bonds at $75 each	450.00	
		2,700.00
Gain realized		2,325.60

(d) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange is recognized at the time of exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454-1.

(e) The gain on the four $100 series E bonds, determined by using $75 as a basis for each such bond, must be included in B's gross income for the taxable year in which such bonds are redeemed or disposed of, or reach final maturity, whichever is earlier.

Example (3). (a) The facts are the same as in example (2), except that, as part of the transaction, the $1,000 series E bond is reissued by considering ten $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the $100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

(b) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange qualifying under section 1037(a) is recognized at the time of the exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) realized on such exchange must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454-1.

(c) The redemption on October 1, 1963, of the four $100 series E bonds considered to have been issued at such time results in gain of $258.40, which is then recognized and must be included in B's gross income for 1963. This gain of $258.40 is the difference between the $558.40 redemption value of such bonds on the date of the exchange and the $300 (4×$75) paid for such series E bonds in 1943.

Example (4). On November 1, 1963, C purchased for $91 a marketable U.S. bond which was originally issued at its par value of $100 under the Second Liberty Bond Act. On February 1, 1964, in an exchange qualifying under section 1037(a), C surrendered the bond to the United States for another marketable U.S. bond, which then had a fair market value of $92, and $1.85 in cash, $0.85 of which was interest. The $0.85 interest received is includible in gross income for the taxable year of the exchange, but the $2 gain ($93 less $91) realized on the exchange is recognized for such year under section 1031(b) to the extent of $1 (the money received). Under section 1031(d), C's basis in the bond received in exchange is $91 (his basis of $91 in the bond surrendered, reduced by the $1 money received and increased by the $1 gain recognized).

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See § 1.1031(d)-2, examples (1) and (2).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967]

§ 1.1031(c)-1 Nonrecognition of loss.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), 1036(a), or 1037(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss. See example (4) of paragraph (a)(3) of § 1.1037-1 for an illustration of the application of this section in the case of an exchange of U.S. obligations described in section 1037(a).

[T.D. 6935, 32 FR 15822, Nov. 17, 1967]

§ 1.1031(d)-1 Property acquired upon a tax-free exchange.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	$2,500
Less: Amount of money received	200
Difference	2,300
Plus: Amount of gain recognized	100
Basis of truck acquired by A	2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $10,000 and a fair market value of $11,000. The stock transferred has an adjusted basis of $4,000 and a fair market value of $2,000. The real estate acquired has a fair market value of $13,000. A is deemed to have received a $2,000 portion of the acquired real estate in exchange for the stock, since $2,000 is the fair market value of the stock at the time of the exchange. A $2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	$10,000
Adjusted basis of stock transferred	4,000
	14,000
Less: Loss recognized on transfer of stock	2,000
Basis of real estate acquired upon the exchange	12,000

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15823, Nov. 17, 1967]

§ 1.1031(d)–2 Treatment of assumption of liabilities.

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example (1). B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received		$600,000
Cash		50,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		800,000
Less: Adjusted basis of property transferred		500,000
Gain realized		300,000
Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows: Adjusted basis of property transferred		500,000
Less: Amount of money received:		
Cash	$50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference		300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

Example (2). (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $100,000, a fair market value of $220,000, but is subject to a mortgage of $80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $175,000, a fair market value of $250,000, but is subject to a mortgage of $150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore $40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $120,000 on the exchange, computed as follows:

Value of property received		$250,000
Cash		40,000
Liabilities subject to which old property was transferred		80,000
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$100,000	
Liabilities to which new property is subject	150,000	
		250,000
Gain realized		120,000

For purposes of section 1031(b), the amount of "other property or money" received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as "other property or money" for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred		$100,000
Liabilities to which new property is subject		150,000
Total		250,000
Less: Amount of money received: Cash	$40,000	
Amount of liabilities subject to which property was transferred	80,000	
		120,000
Difference		130,000
Plus: Amount of gain recognized upon the exchange		40,000
Basis of property acquired upon the exchange		170,000

(c) E realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received		$220,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
		295,000
Gain realized		75,000

For purposes of section 1031(b), the amount of "other property or money" received by E is $30,000. (Consideration received by E in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by E is $175,000, computed as follows:

Adjusted basis of property transferred		$175,000
Cash		40,000
Liabilities to which new property is subject		80,000
Total		295,000
Less: Amount of money received:		
Amount of liabilities subject to which property was transferred	$150,000	
		150,000
Difference		145,000
Plus: Amount of gain recognized upon the exchange		30,000
Basis of property acquired upon the exchange		175,000

§ 1.1031(e)-1 Exchanges of livestock of different sexes.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

§ 1.1032-1 Disposition by a corporation of its own capital stock.

(a) The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. For example, the receipt by a corporation of the subscription price of shares of its stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be equal to, in excess of, or less than, the par or stated value of such stock. Also, the exchange or sale by a corporation of its own shares for money or other property does not result in taxable gain or deductible loss, even though the corporation deals in such shares as it might in the shares of another corporation. A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.

(b) Section 1032(a) does not apply to the acquisition by a corporation of shares of its own stock except where the corporation acquires such shares in exchange for shares of its own stock (including treasury stock). See paragraph (e) of § 1.311-1, relating to treatment of acquisitions of a corporation's own stock. Section 1032(a) also does not relate to the tax treatment of the recipient of a corporation's stock.

(c) Where a corporation acquires shares of its own stock in exchange for shares of its own stock (including treasury stock) the transaction may qualify not only under section 1032(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights).

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§ 1.1033(a)-1 Involuntary conversions; nonrecognition of gain.

(a) *In general.* Section 1033 applies to cases where property is compulsorily or involuntarily converted. An "involuntary conversion" may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An "involuntary conversion" may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) *Special rules.* For rules relating to the application of section 1033 to involuntary conversions of a principal residence with respect to which an election has been made under section 121 (relating to gain from sale or exchange of residence of individual who has attained age 65), see paragraph (g) of § 1.121-5. For rules applicable to involuntary conversions of a principal residence occurring before January 1, 1951, see § 1.1033(a)-3. For rules applicable to involuntary conversions of a principal residence occurring after December 31, 1950, and before January 1, 1954, see paragraph (h)(1) of § 1.1034-1. For rules applicable to involuntary conversions of a personal residence occurring after December 31, 1953, see § 1.1033(a)-3. For special rules relating to the election to have section 1034 apply to certain involuntary conversions of a principal reisdence occurring after December 31, 1957, see paragraph (h)(2) of § 1.1034-1. For special rules relating to certain involuntary conversions of real property held either for productive use in trade or business or for investment and occurring after December 31, 1957, see § 1.1033(g)-1. See also special rules applicable to involuntary conversions of property sold pursuant to reclamation laws, livestock destroyed by disease, and livestock sold on account of drought provided in §§ 1.1033(c)-1, 1.1033(d)-1, and 1.1033(e)-1, respectively. For rules relating to basis of property acquired through involuntary conversions, see § 1.1033(b)-1. For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 1223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332(b)(3) and regulations issued thereunder.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13318, Oct. 20, 1965; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(a)-2 Involuntary conversion into similiar property, into money or into dissimilar property.

(a) *In general.* The term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property.* (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation

should be in the form of an "amended return". If a decision is made to make an election under section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending 2 years (or, in the case of a disposition occurring before Dec. 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of 2 years (or, in the case of a disposition occurring before Dec. 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain from the conversion is realized, unless the taxpayer can show to the satisfaction of the district director—

(i) Reasonable cause for not having filed the application within the required period of time, and

(ii) The filing of such application was made within a reasonable time after the expiration of the required period of time. The application shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

See section 1033(g)(4) and § 1.1033(g)-1 for the circumstances under which, in the case of the conversion of real property held either for productive use in trade or business or for investment, the 2-year period referred to in this paragraph (c)(3) shall be extended to 3 years.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(b), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayers unadjusted basis of the replacement property would be determined, in the absence of section 1033(b), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a)(2), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If re-

placement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(2) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(2), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase or a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the "amount realized" upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the "amount realized" by the taxpayer.

(12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6679, 28 FR 10515, Oct. 1, 1963; T.D. 7075, 35 FR 17996, Nov. 24, 1970; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(a)-3 Involuntary conversion of principal residence.

Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. However, section 1033 shall not apply to the seizure, requisition, or condemnation (but not destruction), or the sale or exchange under threat or imminence thereof, of such residence property if the seizure, requisition, condemnation, sale, or exchange occurs after December 31, 1957, and if the taxpayer properly elects under section 1034(i) to treat the transaction as a sale (see paragraph (h)(2)(ii) of § 1.1034-1). See section 121 and paragraphs (d) and (g) of § 1.121-5 for special rules relating to the involuntary conversion of a principal residence of individuals who have attained age 65.

[T.D. 6856, 30 FR 13319, Oct. 20, 1965. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(b)-1 Basis of property acquired as a result of an involuntary conversion.

(a) The provisions of the first sentence of section 1033(b) may be illustrated by the following example:

Example. A's vessel which has an adjusted basis of $100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of $200,000. If A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the adjusted basis of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033(b) may be illustrated by the following example:

Example. A taxpayer realizes $22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was $10,000, and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain on the conversion. The basis of the new barn to the taxpayer would be $10,000—the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000). The basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section 1016(b)(2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost $8,000 and $12,000, respectively, then the basis of the two barns would be $4,000 and $6,000, respectively, the total basis of the purchased property ($10,000) allocated in proportion to their respective costs (8,000/20,000 of $10,000 or $4,000; and 12,000/20,000 of $10,000, or $6,000).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 76025, 44 FR 31013, May 30, 1979]

§ 1.1033(c)-1 Disposition of excess property within irrigation project deemed to be involuntary conversion.

(a) The sale, exchange, or other disposition occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of excess lands lying within an irrigation project or division in order to conform to acreage limitations of the Federal reclamation laws effective with respect to such project or division shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. The term "excess lands" means irrigable lands within an irrigation project or division held by one owner in excess of the amount of irrigable land held by such owner entitled to receive water under the Federal reclamation laws applicable to such owner in such project or division. Such excess lands may be either (1) lands receiving no water from the project or division, or (2) lands receiving water only because the owner thereof has executed a valid recordable contract agreeing to sell such lands under terms and conditions satisfactory to the Secretary of the Interior.

(b) If a disposition in order to conform to the acreage limitation provisions of Federal reclamation laws includes property other than excess lands (as, for example, where the excess lands alone do not constitute a marketable parcel) the provisions of section 1033(d) shall apply only to the part of the disposition that relates to excess lands.

(c) The provisions of § 1.1033(a)-2 shall be applicable in the case of dispositions treated as involuntary conversions under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)-2 shall include the authority whereby the lands disposed of are considered "excess lands", as defined in this section, and a statement that such disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division.

(d) The term "involuntary conversion", where it appears in subtitle A of the Code or the regulations thereunder, includes dispositions of excess property within irrigation projects described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(d)-1 Destruction or disposition of livestock because of disease.

(a) The destruction occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of livestock by, or on account of, disease, or the sale or exchange, in such a year, of livestock because of disease, shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. Livestock which are killed either because they are diseased or because of exposure to disease shall be considered destroyed on account of disease. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease.

(b) The provisions of § 1.1033(a)-2 shall be applicable in the case of a disposition treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)-2 shall include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.

(c) The term "involuntary conversion," where it appears in subtitle A of the Code or the regulations thereunder, includes disposition of livestock described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(e)-1 Sale or exchange of livestock solely on account of drought.

(a) The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell or exchange during the taxable year if he followed his usual business practices shall be treated as an involuntary conversion to which section 1033 and the regulations thereunder are applicable if the sale or exchange of such livestock by the taxpayer is solely on account of drought. Section 1033(e) and this section shall apply only to sales and exchanges occurring after December 31, 1955.

(b) To qualify under section 1033(e) and this section, the sale or exchange of the livestock need not take place in a drought area. While it is not necessary that the livestock be held in a drought area, the sale or exchange of the livestock must be solely on account of drought conditions the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(c) The total sales or exchanges of livestock held for draft, breeding, or dairy purposes occurring in any taxable year which may qualify as an involuntary conversion under section 1033(e) and this section is limited to the excess of the total number of such livestock sold or exchanged during the taxable year over the number that the taxpayer would have sold or exchanged if he had followed his usual business practices, that is, the number he would have been expected to sell or exchange under ordinary circumstances if there had been no drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually one-half of his herd of dairy cows, only the number sold or exchanged solely on account of drought conditions which is in excess of one-half of his herd, may qualify as an involuntary conversion under section 1033(e) and this section.

(d) The replacement requirements of section 1033 will be satisfied only if the livestock sold or exchanged is replaced within the prescribed period with livestock which is similar or related in service or use to the livestock sold or exchanged because of drought, that is, the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held. Thus, although dairy cows could be replaced by dairy cows, a taxpayer could not replace draft animals with breeding or dairy animals.

(e) The provisions of § 1.1033(a)-2 shall be applicable in the case of a sale or exchange treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)-2 shall include:

(1) Evidence of the existence of the drought conditions which forced the sale or exchange of the livestock;

(2) A computation of the amount of gain realized on the sale or exchange;

(3) The number and kind of livestock sold or exchanged; and

(4) The number of livestocks of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.

(f) The term "involuntary conversion", where it appears in subtitle A of the Code or the regulations thereunder, includes the sale or exchange of livestock described in this section.

(g) The provisions of section 1033(e) and this section apply to taxable years ending after December 31, 1955, but only in the case of sales or exchange of livestock after December 31, 1955.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(g)-1 Condemnation of real property held for productive use in trade or business or for investment.

(a) *Special rule in general.* This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of § 1.1031(a)-1.

(b) *Election to treat outdoor advertising displays as real property*—(1) *In general.* Under section 1033(g)(3) of the Code, a taxpayer may elect to treat property which constitutes an outdoor advertising display as real property for purposes of chapter 1 of the Code. The election is available for taxable years beginning after December 31, 1970. In the case of an election made on or before July 21, 1981, the election is available whether or not the period for filing a claim for credit or refund under section 6511 has expired. No election may be made with respect to any property for which (i) the investment credit under section 38 has been claimed, or (ii) an election of additional first-year depreciation allowance for small business under section 179(a) is in effect. The election once made applies to all outdoor advertising displays of the taxpayer which may be made the subject of an election under this paragraph, including all outdoor advertising displays acquired or constructed by the taxpayer in a taxable year after the taxable year for which the election is made. The election applies with respect to dispositions during the taxable year for which made and all subsequent taxable years (unless an effective revocation is made pursuant to paragraph (b)(2) (ii) or (iii)).

(2) *Election*—(i) *Time and manner of making election*—(A) *In general.* Unless otherwise provided in the return or in the instructions for a return for a taxable year, any election made under section 1033(g)(3) shall be made by attaching a statement to the return (or amended return if filed on or before July 21, 1981 for the first taxable year to which the election is to apply. Any election made under this paragraph must be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for such taxable year or July 21, 1981, whichever occurs last. If a taxpayer makes an election (or revokes an election under subdivision (ii) or (iii) of this subparagraph (b) (2)) for a taxable year for which he or she has previously filed a return, the return for that taxable year and all other taxable years affected by the election (or revocation) must be amended to reflect any tax consequences of the election (or revocation). However, no return for a taxable year for which the period for filing a claim for credit or refund under section 6511 has expired may be amended to make any changes other than those resulting from the election (or revocation). In order for the election (or revocation) to be effective, the taxpayer must remit with the amended return any additional tax due resulting from the election (or revocation), notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any other law which would prevent assessment or collection of such tax.

(B) *Statement required when making election.* The statement required when making the election must clearly indicate that the election to treat outdoor advertising displays as real property is being made.

(ii) *Revocation of election by Commissioner's consent.* Except as otherwise provided in paragraph (b)(2)(iii) of this section, an election under section 1033(g)(3) shall be irrevocable unless consent to revoke is obtained from the Commissioner. In order to secure the Commissioner's consent to revoke an election, the taxpayer must file a request for revocation of election with the Commissioner of Internal Revenue, Washington, D.C. 20224. The request for revocation shall include—

(A) The taxpayer's name, address, and taxpayer identification number,

(B) The date on which and taxable year for which the election was made and the Internal Revenue Service office with which it was filed,

(C) Identification of all outdoor advertising displays of the taxpayer to which the revocation would apply (including the location, date of purchase, and adjusted basis in such property),

(D) The effective date desired for the revocation, and

(E) The reasons for requesting the revocation.

The Commissioner may require such other information as may be necessary in order to determine whether the requested revocation will be permitted. The Commissioner may prescribe administrative procedures (subject to such limitations, terms and conditions as he deems necessary) to obtain his consent to permit the taxpayer to revoke the election. The taxpayer may submit a request for revocation for any taxable year for which the period of limitations for filing a claim for credit or refund or overpayment of tax has not expired.

(iii) *Revocation where election was made on or before December 11, 1979.* In the case of an election made on or before December 11, 1979, the taxpayer may revoke such election provided such revocation is made not later than March 23, 1981. The request for revocation shall be made in conformity with the requirements of paragraph (b)(2)(ii), except that, in lieu of the information required by paragraph (b)(2)(ii)(E), the taxpayer shall state that the revocation is being made pursuant to this paragraph. In addition, the taxpayer must forward, with the statement of revocation, copies of his or her tax returns, including both the original return and any amended returns, for the taxable year in which the original election was made and for all subsequent years and must remit any additional tax due as a result of the revocation.

(3) *Definition of outdoor advertising display.* The term "outdoor advertising display" means a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently atttached to a building or other inherently permanent structure. The term includes highway billboards affixed to the ground with wood or metal poles, pipes, or beams, with or without concrete footings.

(4) *Character of replacement property.* For purposes of section 1033(g), an interest in real property purchased as replacement property for a compulsorily or involuntarily converted outdoor advertising display (with respect to which an election under this section is in effect) shall be considered property of a like kind as the property converted even though a taxpayer's interest in the replacement property is different from the interest held in the property converted. Thus, for example, a fee simple interest in real estate acquired to replace a converted billboard and a 5-year leasehold interest in the real property on which the billboard was located qualifies as property of a like kind under this section.

(c) *Special rule for period within which property must be replaced.* In the case of a disposition described in paragraph (a) of this section, section 1033(a)(2)(B) and § 1.1033(a)-2(c)(3) (relating to the period within which the property must be replaced) shall be applied by substituting 3 years for 2 years. This paragraph shall apply to any disposition described in section 1033(f)(1) and paragraph (a) of this section occurring after December 31, 1974, unless a condemnation proceeding with respect to the property was begun before October 4, 1976. Thus, regardless of when the property is disposed of, the taxpayer will not be eligible for the 3-year replacement period if a condemnation proceeding was begun before October 4, 1976. However, if the property is disposed of after December 31, 1974, and the condemnation proceeding was begun (if at all) after October 4, 1976, then the taxpayer is eligible for the 3-year replacement period. For the purposes of this paragraph, whether a condemnation proceeding is considered as having begun is determined under the applicable State or Federal procedural law.

(d) *Limitation on application of special rule.* This section shall not apply to the purchase of stock in the acquisition of control of a corporation described in section 1033(a)(2)(A).

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979; 44 FR 38458, July 2, 1979, and by T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(h)-1 Effective date.

Except as provided otherwise in § 1.1033(e)-1 and § 1.1033(g)-1, the provisions of section 1033 and the regulations thereunder are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979, and by T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1034-1 Sale or exchange of residence.

(a) *Nonrecognition of gain; general statement.* Section 1034 provides rules for the nonrecognition of gain in certain cases where a taxpayer sells one residence after December 31, 1953, and buys or builds, and uses as his principal residence, another residence within specified time limits before or after such sale. In general, if the taxpayer invests in a new residence an amount at least as large as the adjusted sales price of his old residence, no gain is recognized on the sale of the old residence (see paragraph (b) of this section for definitions of "adjusted sales price", "new residence", and "old residence"). On the other hand, if the new residence costs the taxpayer less than the adjusted sales price of the old residence, gain is recognized to the extent of the difference. Thus, if an amount equal to or greater than the adjusted sales price of an old residence is invested in a new residence, according to the rules stated in section 1034, none of the gain (if any) realized from the sale shall be recognized. If an amount less than such adjusted sales price is so invested, gain shall be recognized, but only to the extent provided in section 1034. If there is no investment in a new residence, section 1034 is inapplicable and all of the gain shall be recognized. Whenever, as a result of the application of section 1034, any or all of the gain realized on the sale of an old residence is not recognized, a corresponding reduction must be made in the basis of the new residence. The provisions of section 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable. Section 1034 applies only to gains; losses are recognized or not recognized without regard to the provisions of this section. Section 1034 affects only the amount of gain recognized, and not the amount of gain realized (see also section 1001 and the regulations issued thereunder). Any gain realized upon disposition of other property in exchange for the new residence is not affected by section 1034. For special rules relating to the sale or exchange of a principal residence by a taxpayer who has attained age 65, see section 121 and paragraph (g) of § 1.121-5. For special rules relating to a case where real property with respect to the sale of which gain is not recognized under this section is reacquired by the seller in partial or full satisfaction of the indebtedness arising from such sale and resold by him within 1 year after the date of such reacquisition, see § 1.1038-2.

(b) *Definitions.* The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):

(1) "Old residence" means property used by the taxpayer as his principal residence which is the subject of a sale by him after December 31, 1953 (section 1034(a); for detailed explanation see paragraph (c)(3) of this section).

(2) "New residence" means property used by the taxpayer as his principal residence which is the subject of a purchase by him (section 1034(a); for detailed explanation and limitations see paragraph (c)(3) and (d)(1) of this section).

(3) "Adjusted sales price" means the amount realized reduced by the fixing-up expenses (section 1034(b)(1); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section).

(4) "Amount realized" is to be computed by subtracting

(i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the consideration received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from

(ii) The amount of the consideration so received, determined (in accordance with section 1001(b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the "amount realized."

(5) "Gain realized" is the excess (if any) of the amount realized over the adjusted basis of the old residence (see also section 1001(a) and regulations issued thereunder).

(6) "Fixing-up expenses" means the aggregate of the expenses for work performed (in any taxable year, whether beginning before, on, or after January 1, 1954) on the old residence in order to assist in its sale, provided that such expenses (i) are incurred for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into; and (ii) are paid on or before the 30th day after the date of the sale of the old residence; and (iii) are neither (a) allowable as deductions in computing taxable income under section 63(a), nor (b) taken into account in computing the amount realized from the sale of the old residence (section 1034(b) (2) and (3)). "Fixing-up expenses" does not include expenditures which are properly chargeable to capital account and which would, therefore, constitute adjustments to the basis of the old residence (see section 1016 and regulations issued thereunder).

(7) "Cost of purchasing the new residence" means the total of all amounts which are attributable to the acquisition, construction, reconstruction, and improvements constituting capital expenditures, made during the period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of sale of the old residence and ending either (i) 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date in the case of a new residence purchased but not constructed by the taxpayer, or (ii) two years (18 months in the case of a sale of an old residence prior to January 1, 1975) after such date in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date (section 1034(a), (c)(2) and (c)(5); for detailed explanation, see paragraph (c)(4) of this section; for special rule applicable in some cases to husband and wife, see paragraph (f) of this section; see also paragraph (b)(9) of this section for definition of "purchase").

(8) "Sale" (of a residence) means a sale or an exchange (of a residence) for other property which occurs after December 31, 1953, an involuntary conversion (of a residence) which occurs after December 31, 1950, and before January 1, 1954, or certain involuntary conversions where the disposition of the property occurs after December 31, 1957, in respect of which a proper election is made under section 1034(i)(2) (see sections 1034(c)(1), 1034(i)(1)(A), and 1034(i)(2); for detailed explanation concerning involuntary conversions, see paragraph (h) of this section).

(9) "Purchase" (of a residence) means a purchase or an acquisition (of a residence) on the exchange of property or the partial or total construction or reconstruction (of a residence) by the taxpayer (section 1034(c) (1) and (2)). However, the mere improvement of a residence, not amounting to reconstruction, does not constitute "purchase" of a residence.

(c) *Rules for application of section 1034*—(1) *General rule; limitations on applicability.* Gain realized from the sale (after December 31, 1953) of an old residence will be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence, provided that the taxpayer either (i) within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of such sale and ending 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date purchases property and uses it as his principal residence, or (ii) within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of such sale and ending two years (18 months in the case of a sale of an old residence prior to January 1, 1975) after such date uses as his principal residence a new residence the construction of which was commenced by him at any time before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the date of the sale of the old residence (section 1034(a) and (c)(5); for detailed explanation of use as "principal residence" see subparagraph (3) of this paragraph). The rule stated in the preceding sentence applies to a new residence purchased by the taxpayer before the date of sale of the old residence provided the new residence is still owned by him on such date (section 1034(c)(3)). Whether the construction of a new residence was commenced by the taxpayer before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the date of the sale of the old residence will depend upon the facts and circumstances of each case. Section 1034 is not applicable to the sale of a residence if within the previous 18 months (previous year in the case of a sale of an old residence prior to January 1, 1975) the taxpayer made another sale of residential property on which gain was realized but not recognized (section 1034(d)). For further details concerning limitations on the application of section 1034, see paragraph (d) of this section.

(2) *Computation and examples.* In applying the general rule stated in subparagraph (1) of this paragraph, the taxpayer should first subtract the commissions and other selling expenses from the selling price of his old residence, to determine the amount realized. A comparison of the amount realized with the cost or other basis of the old residence will then indicate whether there is any gain realized on the sale. Unless the amount realized is greater than the cost or other basis, no gain is realized and section 1034 does not apply. If the amount realized exceeds the cost or other basis, the amount of such excess constitutes the gain realized. The amount realized should then be reduced by the fixing-up expenses (if any), to determined the adjusted sales price. A comparison of the adjusted sales price of the old residence with the cost of purchasing the new residence will indicate how much (if any) of the realized gain is to be recognized. If the cost of purchasing the new residence is the same as, or greater than, the adjusted sales price of the old residence, then none of the realized gain is to be recognized. On the other hand, if the cost of purchasing the new residence is smaller than the adjusted sales price of the old residence, the gain realized, all of the gain realized is to be recognized to the extent of the difference. It should be noted that any amount of gain realized but not recognized is to be applied as a downward adjustment to the basis of the new residence (for details see paragraph (e) of this section).) The application of the general rule stated above may be illustrated by the following examples:

Example (1). A taxpayer decides to sell his residence, which has a basis of $17,500. To make it more attractive to buyers, he paints the outside at a cost of $300 in April, 1954. He pays for the painting when the work is finished. In May, 1954, he sells the house for $20,000. Brokers' commissions and other selling expenses are $1,000. In October, 1954, the taxpayer buys a new residence for $18,000. The amount realized, the gain realized, the adjusted sales price, and the gain to be recognized are computed as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing new residence	18,000
Gain recognized	700
Gain realized but not recognized	800
Adjusted basis of new residence (see paragraph (e) of this section)	17,200

Example (2). The facts are the same as in example (1), except that the selling price of the old residence is $18,500. The computations are as follows:

Selling price	$18,500
Less: Commissions and other selling expenses	1,000
Amount realized	17,500
Less: Basis	17,500
Gain realized	0

NOTE: Since no gain is realized, section 1034 is inapplicable; it is, therefore, unnecessary to compute the adjusted sales price of the old residence and compare it with the cost of purchasing the new residence. No adjustment to the basis of the new residence is to be made.

Example (3). The facts are the same as in example (1), except that the cost of purchasing the new residence is $17,000. The computations are as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing the new residence	17,000
Gain recognized	1,500

Note: Since the adjusted sales price of the old residence exceeds the cost of purchasing the new residence by $1,700, which is more than the gain realized, all of the gain realized is recognized. No adjustment to the basis of the new residence is to be made.

Gain realized but not recognized	$0

Example (4). The facts are the same as in example (1), except that the fixing-up expenses are $1,100. The computations are as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	1,100
Adjusted sales price	17,900
Cost of purchasing the new residence	18,000
Gain recognized	0

Note: Since the cost of purchasing the new residence exceeds the adjusted sales price, none of the gain realized is recognized.

Gain realized but not recognized	$1,500
Adjusted basis of new residence (see paragraph (e) of this section)	16,500

(3) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034(f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(4) *Cost of purchasing new residence.* (i) The taxpayer's cost of purchasing the new residence includes not only cash but also any indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determin-

ing such cost. In the case of an acquisition of a residence upon an exchange which is considered as a "purchase" under this section, the fair market value of the new residence on the date of the exchange shall be considered as the taxpayer's cost of purchasing the new residence. Where any part of the new residence is acquired by the taxpayer other than by "purchase", the value of such part is not to be included in determining the taxpayer's cost of the new residence (see paragraph (b)(9) of this section for definition of "purchase"). For example, if the taxpayer acquires a residence by gift or inheritance, and spends $20,000 in reconstructing such residence, only such $20,000 may be treated as his cost of purchasing the new residence.

(ii) The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the period of three years or 42 months (two years or 30 months in the case of a sale of an old residence prior to January 1, 1975), as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Thus, if the construction of the new residence is begun three years before the date of sale of the old residence and completed on the date of sale of the old residence, only that portion of the cost which is attributable to the last 18 months (last year in the case of a sale of an old residence prior to January 1, 1975) of such construction constitutes the taxpayer's cost of purchasing the new residence, for purposes of section 1034. Furthermore, the taxpayer's cost of purchasing the new residence includes only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see section 263.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. M began the construction of a new residence on January 15, 1974, and completed it on October 14, 1974. The cost of $45,000 was incurred ratably over the 9-month period of construction. On December 14, 1975, M sold his old residence and realized a gain. In determining the extent to which the realized gain is not to be recognized under section 1034, M's cost of constructing the new residence shall include only the $20,000 which was attributable to the June 15—October 14, 1974, period (4 months at $5,000). The $25,000 balance of the cost of constructing the new residence was not attributable to the period beginning 18 months before the date of the sale of the old residence and ending two years after such date and, under section 1034, is not properly a part of M's cost of constructing the new residence.

(d) *Limitations on application of section 1034.* (1) If a residence is purchased by the taxpayer prior to the date of the sale of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence (section 1034(c)(3)). And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the 18 months (or two years in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence (section 1034(c)(4)). In the case of a sale of an old residence prior to January 1, 1975, the period of 18 months (or two years) referred to in the preceding sentence shall be one year (or 18 months). If within 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section or section 112(n) of the Internal Revenue Code of 1939, this section shall not apply with respect to the sale of the old residence (section 1034(d)).

(2) The following example will illustrate the rules of subparagraph (1) of this paragraph:

Example. A taxpayer sells his old residence on January 15, 1954, and purchases another residence on February 15, 1954. On March 15, 1954, he sells the residence which he bought on February 15, 1954, and purchases another residence on April 15, 1954. The gain on the sale of the old residence on January 15, 1954, will not be recognized except to the extent to which the taxpayer's adjusted sales price of the old residence exceeds the cost of purchasing the residence which he purchased on April 15, 1954. Gain on the sale of the residence which was bought on February 15, 1954, and sold on March 15, 1954, will be recognized.

(e) *Basis of new residence.* (1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of the gain realized upon the sale of an old residence, then, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain which was not recognized upon the sale of the old residence (section 1034(e); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section). Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1) of this paragraph:

Example. On January 1, 1954, the taxpayer buys a new residence for $10,000. On March 1, 1954, he sells for an adjusted sales price of $15,000 his old residence, which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $15,000 is the "amount realized" as well as the "adjusted sales price"). Between April 1 and April 15 a wing is constructed on the new house at a cost of $5,000. Between May 1 and May 15 a garage is constructed at a cost of $2,000. The adjusted basis of the new residence is $10,000 during January and February, $5,000 during March, $5,000 following the completion of the construction in April, and $7,000 following the completion of the construction in May. Since the old residence was not sold until March 1, no adjustment to the basis of the new residence is made during January and February. Computations for March, April, and May are as follows:

Amount realized on sale of old residence	$15,000
Less: Adjusted basis of old residence	5,000
Gain realized on sale of old residence	10,000
March 1, 1954	
Adjusted sales price of old residence	$15,000
Less: Cost of purchasing new residence	10,000
Gain recognized	5,000
Gain realized but not recognized	5,000
Cost of purchasing new residence	10,000
Less: Gain realized but not recognized	5,000
Adjusted basis of new residence	5,000
April 15, 1954	
Gain realized on sale of old residence	10,000
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	15,000
Gain recognized	0
Gain realized but not recognized	10,000
Cost of purchasing new residence	15,000
Less: Gain realized but not recognized	10,000
Adjusted basis of new residence	5,000
May 15, 1954	
Gain realized on sale of old residence	10,000
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	17,000
Gain recognized	0
Gain realized but not recognized	10,000
Cost of purchasing new residence	17,000
Less: Gain realized but not recognized	10,000
Adjusted basis of new residence	7,000

(f) *Husband and wife.* (1) If the taxpayer and his spouse file the consent referred to in this paragraph, then the "taxpayer's adjusted sales price of the old residence" shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the "taxpayer's cost of purchasing the new residence" shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (section 1034(g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(2) The consent referred to in subparagraph (1) of this paragraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided. Such consent shall be filed with the district director with whom the taxpayer filed the return for the taxable year or years in which the gain from the sale of the old residence was realized.

(3) The following examples will illustrate the application of this rule:

Example (1). A taxpayer, in 1954, sells for an adjusted sales price of $10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale he and his wife contribute $5,000 each from their separate funds for the purchase of their new principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of $5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be $2,500 and the adjusted basis of his wife's interest in such property will be $2,500.

Example (2). A taxpayer and his wife, in 1954, sell for an adjusted sales price of $10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of $2,500 to each of them ($5,000 together) (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale, the wife spends $10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her name only. If the taxpayer and his wife file the required consent, the adjusted basis to the wife of the new residence will be $5,000, and the gain of the taxpayer will be $2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of $2,500 on the sale of the old residence not recognized under the general rule.

(g) *Members of Armed Forces.* (1) Section 1034(h) provides a special rule for members of the Armed Forces with respect to the period after the sale of the old residence within which the acquisition of a new residence may result in a non-recognition of gain on such sale. The running of the period of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the sale of the old residence in the case of the purchase of a new residence, or the period of two years (18 months in the case of a sale of an old residence prior to January 12, 1975) after such sale in the case of the construction of a new residence, is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces of the United States. (This paragraph applies to time served on extended active duty prior to July 1, 1973, only if such extended active duty occurred during an induction period as defined in section 112(c)(5) as in effect prior to July 1, 1973.) However, in no event may such suspension extend for more than four years after the date of the sale of the old residence the period within which the purchase or construction of a new residence may result in a nonrecognition of gain. For example, if the taxpayer is on extended active duty with the Army from January 1, 1975, to June 30, 1976, and if he sold his old residence on January 10, 1975, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of his old residence not recognized under this section is June 30, 1978 (the date two years following the taxpayer's termination of active duty). However, if this taxpayer were on extended active duty with the Army from January 1, 1975, to December 31, 1978, the latest date on which he might use a new residence constructed by him and have any part of the gain on the sale of his old residence not recognized under this section would be January 10, 1979 (the date four years following the date of the sale of the old residence).

(2) This suspension covers not only the Armed Forces service of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (c)(4) of this section.

(4) The running of the period of 18 months (or two years) after the date of sale of the old residence referred to in section 1034(c)(4) and in paragraph (d) of this section is not suspended. The running of the 18-month period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section is also not suspended. In the case of a sale of an old residence prior to January 1, 1975, the periods of 18 months (or two years) referred to in each of the two preceding sentences shall be one year (or 18 months).

(5) The term "extended active duty" means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days, if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see paragraph (i) of § 1.112-1. As to who are members of the Armed Forces of the United States, see section 7701(a)(15), and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

(h) *Special rules for involuntary conversions*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, section 1034 is inapplicable to involuntary conversions of personal residences occurring after December 31, 1953 (section 1034(i)(1)(B)). For purposes of section 1034, an involuntary conversion of a personal residence occurring after December 31, 1950, and before January 1, 1954, is treated as a sale of such residence (section 1034(i)(1)(A); see paragraph (b)(8) of this section). For purposes of this paragraph, an involuntary conversion is defined, as the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. See section 1033 and § 1.1033(a)-3 for treatment of residences involuntarily converted after December 31, 1953.

(2) *Election to treat condemnation of personal residence as sale.* (i) Section 1034(i)(2) provides a special rule which permits a taxpayer to elect to treat the seizure, requisition, or condemnation of his principal residence, or the sale or exchange of such residence under threat or imminence thereof, if occurring after December 31, 1957, as the sale of such residence for purposes of section 1034 (relating to sale or exchange of residence). A taxpayer may thus elect to have section 1034 apply, rather than section 1033 (relating to involuntary conversions), in determining the amount of gain realized on the disposition of his old residence that will not be recognized and the extent to which the basis of his new residence acquired in lieu thereof shall be reduced. Once made, the election shall be irrevocable.

(ii) If the taxpayer elects to be governed by the provisions of section 1034, section 1033 will have no application. Thus, a taxpayer who elects under section 1034(i)(2) to treat the seizure, requisition, or condemnation of his principal residence (but not the destruction), or the sale or exchange of such residence under threat or imminence thereof, as a sale for the purpose of section 1034 must satisfy the requirements of section 1034 and this section. For example, under section 1034 a taxpayer generally must replace his old residence with a new residence which he uses as his principal residence, within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of disposition of his old residence, and ending 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date. However, in the case of a new residence the construction of which was commenced by the taxpayer within such period, the replacement period shall not expire until 2 years (18 months in the case of a sale of an old residence prior to January 1, 1975) after the date of disposition of the old residence.

(iii) *Time and manner of making election.* The election under section 1034(i)(2) shall be made in a statement attached to the taxpayer's income tax return, when filed, for the taxable year during which the disposition of his old residence occurs. The statement shall indicate that the taxpayer elects under section 1034(i)(2) to treat the disposition of his old residence as a sale for purposes of section 1034, and shall also show—

(*a*) The basis of the old residence;

(*b*) The date of its disposition;

(*c*) The adjusted sales price of the old residence, if known; and

(*d*) The purchase price, date of purchase, and date of occupancy of the new residence if it has been acquired prior to the time of making the election.

(i) *Statute of limitations.* (1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 6501(a) for the assessment of a deficiency attributable to any part of such gain shall not expire prior to the expiration of three years from the date of receipt, by the district director with whom the return was filed for the taxable year or years in which the gain from the sale of the old residence was realized (section 1034(j)), of a written notice from the taxpayer of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims result in nonrecognition of any part of such gain.

(ii) The taxpayer's intention not to purchase a new residence within the period when such a purchase will result in nonrecognition of any part of such gain, or

(iii) The taxpayer's failure to make such a purchase within such period.

Any gain from the sale of the old residence which is required to be recognized shall be included in gross income for the taxable year or years in which such gain was realized. Any deficiency attributable to any portion of such gain may be assessed before the expiration of the 3-year period described in this paragraph, notwithstanding the provisions of any law or rule of law which might otherwise bar such assessment.

(2) The notification required by the preceding subparagraph shall contain all pertinent details in connection with the sale of the old residence and, where applicable, the purchase price of the new residence. The notification shall be in the form of a written statement and shall be accompanied, where appropriate, by an amended return for the year in which the gain from the sale of the old residence was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(j) *Effective date.* Pursuant to section 7851(a)(1)(C), paragraphs (a), (b), (c), (d), (f), (g), and (i) of this section apply in the case of any "sale" (as defined in paragraph (b)(8) of this section) made after December 31, 1953, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939. Similarly, the rule in paragraph (h) of this section that involuntary conversions of personal residences are not to be treated as sales for purposes of section 1034 but are governed by section 1033 applies to any such involuntary conversion made after December 31, 1953, although such involuntary conversion may occur in a taxable year subject to the Internal Revenue Code of 1939. The rule in paragraph (e) of this section requiring an adjustment to the basis of a new residence, the purchase of which results (under section 1034, or section 112(n) of the Internal Revenue Code of 1939) in the nonrecognition of gain on the sale of an old residence, applies in determining the adjusted basis of the new residence at any time following such sale, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5924, Apr. 13, 1967; 32 FR 6971, May 6, 1967; T.D. 7404, 41 FR 6758, Feb. 13, 1976; T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1035-1 Certain exchanges of insurance policies.

Under the provisions of section 1035 no gain or loss is recognized on the exchange of:

(a) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract (section 1035(a)(1));

(b) A contract of endowment insurance for another contract of endowment insurance providing for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or an annuity contract (section 1035(a)(2)); or

(c) An annuity contract for another annuity contract (section 1035(a)(3)), but section 1035 does not apply to such exchanges if the policies exchanged to not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031 (b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations thereunder.

§ 1.1036-1 Stock for stock of the same corporation.

(a) Section 1036 permits the exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation. Section 1036 applies even though voting stock is exchanged for nonvoting stock or nonvoting stock is exchanged for voting stock. It is not limited to an exchange between two individual stockholders; it includes a transaction between a stockholder and the corporation. However, a transaction between a stockholder and the corporation may qualify not only under section 1036(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights). The provisions of section 1036(a) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See paragraph (l) of § 1301-1 for certain transactions treated as distributions under section 301. See paragraph (e)(5) of § 1.368-2 for certain transactions which result in deemed distributions under section 305(c) to which sections 305(b)(4) and 301 apply.

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973]

§ 1.1037-1 Certain exchanges of United States obligations.

(a) *Nonrecognition of gain or loss*—(1) *In general.* Section 1037(a) provides for the nonrecognition of gain or loss on the surrender to the United States of obligations of the United States issued under the Second Liberty Bond Act (31 U.S.C. 774(2)) when such obligations are exchanged solely for other obligations issued under that Act and the Secretary provides by regulations promulgated in connection with the issue of such other obligations that gain or loss is not to be recognized on such exchange. It is not necessary that at the time of the exchange the obligation which is surrendered to the United States be a capital asset in the hands of the taxpayer. For purposes of section 1037(a) and this subparagraph, a circular of the Treasury Department which offers to exchange obligations of the United States issued under the Second Liberty Bond Act for other obligations issued under that Act shall constitute regulations promulgated by the Secretary in connection with the issue of the obligations offered to be exchanged if such circular contains a declaration by the Secretary that no gain or loss shall be recognized for Federal income tax purposes on the exchange or grants the privilege of continuing to defer the reporting of the income of the bonds exchanged until such time as the bonds received in the exchange are redeemed or disposed of, or have reached final maturity, whichever is earlier. See, for example, regulations of the Bureau of the Public Debt, 31 CFR Part 339, or Treasury Department Circular 1066, 26 FR 8647. The application of section 1037(a) and this subparagraph will not be precluded merely because the taxpayer is required to pay money on the exchange. See section 1031 and the regulations thereunder if the taxpayer receives money on the exchange.

(2) *Recognition of gain or loss postponed.* Gain or loss which has been realized but not recognized on the exchange of a U.S. obligation for another such obligation because of the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as related to section 1037(a)) shall be recognized at such time as the obligation received in the exchange is disposed of, or redeemed, in a transaction other than an exchange described in section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) or reaches final maturity, whichever is earlier, to the extent gain or loss is realized on such later transaction.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example (1). A, the owner of a $1,000 series E U.S. savings bond purchased for $750 and bearing an issue date of May 1, 1945, surrenders the bond to the United States in exchange solely for series H U.S. savings bonds on February 1, 1964, when the series E bond has a redemption value of $1,304.80. In the exchange A pays an additional $195.20 and obtains three $500 series H bonds. None of the $554.80 gain ($1,304.80 less $750) realized by A on the series E bond is recognized at the time of the exchange.

Example (2). In 1963, B purchased for $97 a marketable U.S. bond which was originally issued at its par value of $100. In 1964 he surrenders the bond to the United States in exchange solely for another marketable U.S. bond which then has a fair market vaue of $95. B's loss of $2 on the old bond is not recognized at the time of the exchange, and his basis for the new bond is $97 under section 1031(d). If it has been necessary for B to pay $1 additional consideration in the exchange, his basis in the new bond would be $98.

Example (3). The facts are the same as in example (2) except that B also receives $1 interest on the old bond for the period which has elapsed since the last interest payment date and that B does not pay any additional consideration on the exchange. As in example (2), B has a loss of $2 which is not recognized at the time of the exchange and his basis in the new bond is $97. In addition, the $1 of interest received on the old bond is includible in gross income. B holds the new bond 1 year and sells it in the market for $99 plus interest. At this time he has a gain of $2, the difference between his basis of $97 in the new bond and the sales price of such bond. In addition, the interest received on the new bond is includible in gross income.

Example (4). The facts are the same as in example (2), except that in addition to the new bond B also receives $1.85 in cash, $0.85 of which is interest. The $0.85 interest received is includible in gross income. B's loss of $1 ($97 less $96) on the old bond is not recognized at the time of the exchange by reason of section 1031(c). Under section 1031(d) B's basis in the new bond is $96 (his basis of $97 in the old bond, reduced by the $1 cash received in the exchange).

Example (5). (a) For $975 D subscribes to a marketable U.S. obligation which has a face value of $1,000. Thereafter, he surrenders this obligation to the United States in exchange solely for a 10-year marketable $1,000 obligation which at the time of exchange has a fair market value of $930, at which price such obligation is initially offered to the public. At the time of issue of the new obligation there was no intention to call it before maturity. Five years after the exchange D sells the new obligation for $960.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation).

(d) On the sale of the new obligation D sustains a loss of $15 ($975 less $960), all of which is recognized by reason of section 1002.

Example (6). (a) The facts are the same as in example (5), except that five years after the exchange D sells the new obligation for $1,020.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation). The issue price of the new obligation under section 1232(b)(2) is $930.

(d) On the sale of the new obligation D realizes a gain of $45 ($1,020 less $975), all of which is recognized by reason of section 1002. Of this gain of $45, the amount of $35 is treated as ordinary income and $10 is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of sec. 1232(a)(2)(B) on sale of new obligation:	
Stated redemption price of new obligation at maturity	$1,000
Less: Issue price of new obligation under sec. 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under sec. 1232(a)(2)(B)(ii): ($70 × 60 months/120 months)	35
(2) Long-term capital gain ($45 less $35)	10

Example (7). (a) The facts are the same as in example (5), except that D retains the new obligation and redeems it at maturity for $1,000.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of $45 ($975 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is $975 (the same basis as that of the old obligation). The issue price of the new obligation is $930 under section 1232(b)(2).

(d) On the redemption of the new obligation D realizes a gain of $25 ($1,000 less $975), all of which is recognized by reason of section 1002. Of this gain of $25, the entire amount is treated as ordinary income, determined as follows:

Ordinary income under first sentence of sec. 1232(a)(2)(B) on redemption of new obligation:	
Stated redemption price of new obligation at maturity	$1,000
Less: Issue price of new obligation under sec. 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under sec. 1232(a)(2)(B)(ii): ($70 × 120 months/120 months), but such amount not to exceed the $25 gain recognized on redemption	25

(b) *Application of section 1232 upon disposition or redemption of new obligation*—(1) *Exchanges involving nonrecognition of gain on obligations issued at a discount.* If an obligation, the gain on which is subject to the first sentence of section 1232(a)(2)(B), because the obligation was originally issued at a discount, is surrendered to the United States in exchange for another obligation and any part of the gain realized on the exchange is not then recognized because of the provisions of section 1037(a) (or because of so much of section 1031(b) as relates to section 1037(a)), the first sentence of section 1232(a)(2)(B) shall apply to so much of such unrecognized gain as is later recognized upon the disposition or redemption of the obligation which is received in the exchange as though the obligation so disposed of or redeemed were the obligation surrendered, rather than the obligation received, in such exchange. See the first sentence of section 1037(b)(1). Thus, in effect that portion of the gain which is unrecognized on the exchange but is recognized upon the later disposition or redemption of the obligation received from the United States in the exchange shall be considered as ordinary income in an amount which is equal to the gain which, by applying the first sentence of section 1232(a)(2)(B) upon the earlier surrender of the old obligation to the United States, would have been considered as ordinary income if the gain had been recognized upon such earlier exchange. Any portion of the gain which is recognized under section 1031(b) upon the earlier exchange and is treated at such time as ordinary income shall be deducted from the gain which is treated as ordinary income by applying the first sentence of section 1232(a)(2)(B) pursuant to this subparagraph upon the disposition or redemption of the obligation which is received in the earlier exchange. This subparagraph shall apply only in a case where on the exchange of United States obligations there was some gain not recognized by reason of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)); it shall not apply where, only loss was unrecognized by reason of section 1037(a).

(2) *Rules to apply when a nontransferable obligation is surrendered in the exchange.* For purposes of applying both section 1232(a)(2)(B) and subparagraph (1) of this paragraph to the total gain realized on the obligation which is later disposed of or redeemed, if the obligation surrendered to the United States in the earlier exchange is a nontransferable obligation described in section 454 (a) or (c)—

(i) The aggregate amount considered, with respect to the obligation so surrendered in the earlier exchange, as ordinary income shall not exceed the difference between the issue price of the surrendered obligation and the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, and

(ii) The issue price of the obligation which is received from the United States in the earlier exchange shall be considered to be the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, increased by the amount of other consideration (if any) paid to the United States as part of the earlier exchange.

If the obligation received in the earlier exchange is a nontransferable obligation described in section 454(c) and such obligation is partially redeemed before final maturity or partially disposed of by being partially reissued to another owner, the amount determined by applying subdivision (i) of this subparagraph shall be determined on a basis proportional to the total denomination of obligations redeemed or disposed of. See paragraph (c) of § 1.454-1.

(3) *Long-term capital gain.* If, in a case where both subparagraphs (1) and (2) of this paragraph are applied, the total gain realized on the redemption or disposition of the obligation which is received from the United States in the exchange to which section 1037(a) (or so much of section 1031(b) as related to section 1037(a)) applies exceeds the amount of gain which, by applying such subparagraphs, is treated as ordinary income, the gain in excess of such amount shall be treated as long-term capital gain.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which

regulations are promulgated pursuant to section 1037(a):

Example (1). (a) A purchased a noninterest-bearing nontransferable U.S. bond for $74 which was issued after December 31, 1954, and redeemable in 10 years for $100. Several years later, when the stated redemption value of such bond is $94.50, A surrenders it to the United States in exchange for $1 in cash and a 10-year marketable bond having a face value of $100. On the date of exchange the bond received in the exchange has a fair market value of $96. Less than one month after the exchange, A sells the new bond for $96.

(b) On the exchange of the old bond for the new bond A realizes a gain of $23, determined as follows:

Amount realized (a new bond worth $96 plus $1 cash)	$97
Less: Adjusted basis of old bond	74
Gain realized	23

Pursuant to so much of section 1031(b) as applies to section 1037(a), the amount of such gain which is recognized is $1 (the money received). Such recognized gain of $1 is treated as ordinary income. On the exchange of the old bond a gain of $22 ($23 less $1) is not recognized.

(c) The basis of the new bond in A's hands, determined under section 1031(d) is $74 (the basis of the old bond, decreased by the $1 received in cash and increased by the $1 gain recognized on the exchange).

(d) On the sale of the new bond A realizes a gain of $22 ($96 less $74), all of which is recognized by reason of section 1002. Of this gain of $22, the amount of $19.50 is treated as ordinary income and $2.50 is treated as long-term capital gain, determined as follows:

(1) Ordinary income, treating sale of new bond as though a sale of old bond and applying sec. 1037(b)(1)(A):		
Stated redemption price of old bond		$94.50
Less: Issue price of old bond		74.00
Aggregate gain under sec. 1037(b)(1)(A) (not to exceed $22 not recognized at time of exchange)		20.50
Less: Amount of such gain recognized at time of exchange		1.00
Ordinary income		19.50
(2) Ordinary income under first sentence of sec. 1232(a)(2)(B), applying sec. 1037(b)(1)(B) to sale of new bond:		
Stated redemption price of new bond at maturity	$100.00	
Less: Issue price of new bond under sec. 1037(b)(1)(B) ($94.50 plus $0 additional consideration paid on exchange)	94.50	
Original issue discount on new bond	$5.50	
Proration under sec. 1232(a)(2)(B)(ii): ($5.50 × 0 months/120 months)		0
(3) Total ordinary income (sum of subparagraphs (1) and (2))		$19.50
(4) Long-term capital gain ($22 less $19.50)		2.50

Example (2). (a) The facts are the same as in example (1), except that, less than one month after the exchange of the old bond, the new bond is sold for $92.

(b) On the sale of the new bond A realizes a gain of $18 ($92 less $74), all of which is recognized by reason of section 1002. Of this gain, the entire amount of $18 is treated as ordinary income. This amount is determined as provided in paragraph (d)(1) of example (1) except that the ordinary income of $19.50 is limited to the $18 recognized on the sale of the new bond.

Example (3). (a) The facts are the same as in example (1), except that 2 years after the exchange of the old bond A sells the new bond for $98.

(b) On the sale of the new bond A realizes a gain of $24 ($98 less $74), all of which is recognized by reason of section 1002. Of this gain of $24, the amount of $20.60 is treated as ordinary income and $3.40 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under sec. 1232(a)(2)(B)(ii) amounts to $1.10 ($5.50 × 24 months/120 months)	1.10
(3) Total ordinary income (sum of subparagraphs (1) and (2))	20.60
(4) Long-term capital gain ($24 less $20.60)	3.40

Example (4). (a) The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for $100.

(b) On the redemption of the new bond A realizes a gain of $26 ($100 less $74), all of which is recognized by reason of section 1002. Of this gain of $26, the amount of $25 is treated as ordinary income and $1 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under sec. 1232(a)(2)(B)(ii) amounts to $5.50 ($5.50 × 120 months/120 months))	5.50

(3) Total ordinary income (sum of subparagraphs (1) and (2))	25.00
(4) Long-term capital gain ($26 less $25)	1.00

Example (5). (a) In 1958 B purchased for $7,500 a series E United States savings bond having a face value of $10,000. In 1965 when the stated redemption value of the series E bond is $9,760, B surrenders it to the United States in exchange solely for a $10,000 series H U.S. savings bond, after paying $240 additional consideration. B retains the series H bond and redeems it at maturity in 1975 for $10,000, after receiving all the semiannual interest payments thereon.

(b) On the exchange of the series E bond for the series H bond, B realizes a gain of $2,260 ($9,760 less $7,500), none of which is recognized at such time by reason of section 1037(a).

(c) The basis of the series H bond in B's hands, determined under section 1031(d), is $7,740 (the $7,500 basis of the series E bond, plus $240 additional consideration paid for the series H bond).

(d) On the redemption of the series H bond, B realizes a gain of $2,260 ($10,000 less $7,740), all of which is recognized by reason of section 1002. This entire gain is treated as ordinary income by treating the redemption of the series H bond as though it were a redemption of the series E bond and by applying section 1037(b)(1)(A).

(e) Under section 1037(b)(1)(B) the issue price of the series H bonds is $10,000 ($9,760 stated redemption price of the series E bond at time of exchange, plus $240 additional consideration paid). Thus, with respect to the series H bond, there is no original issue discount to which section 1232(a)(2)(B) might apply.

Example (6). (a) The facts are the same as in example (5), except that in 1970 B submits the $10,000 series H bond to the United States for partial redemption in the amount of $3,000 and for reissuance of the remainder in $1,000 series H savings bonds registered in his name. On this transaction B receives $3,000 cash and seven $1,000 series H bonds, bearing the original issue date of the $10,000 bond which is partially redeemed. The $1,000, series H bonds are redeemed at maturity in 1975 for $7,000.

(b) On the partial redemption of the $10,000 series H bond in 1970 B realizes a gain of $678 ($3,000 less $2,322 [$7,740×$3,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income, by treating the partial redemption of the series H bond as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the seven $1,000 series H bonds B realizes a gain of $1,582 ($7,000 less $5,418 [$7,740×$7,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

Example (7). (a) The facts are the same as in example (5), except that in 1970 B requests the United States to reissue the $10,000 series H bond by issuing two $5,000 series H bonds bearing the original issue date of such $10,000 bond. One of such $5,000 bonds is registered in B's name, and the other is registered in the name of C, who is B's son. Each $5,000 series H bond is redeemed at maturity in 1975 for $5,000.

(b) On the issuing in 1970 of the $5,000 series H bond to C, B realizes a gain of $1,130 ($5,000 less $3,870 [$7,740×$5,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income by treating the transaction as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the $5,000 series H bond registered in his name B realizes a gain of $1,130 ($5,000 less $3,870 [$7,740×$5,000/$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

(d) On the redemption at maturity in 1975 of the $5,000 series H bond registered in his name C does not realize any gain, since the amount realized on redemption does not exceed his basis in the property, determined as provided in section 1015.

(5) *Exchanges involving nonrecognition of gain or loss on transferable obligations issued at not less than par*—(i) *In general.* If a transferable obligation of the United States which was originally issued at not less than par is surrendered to the United States for another transferable obligation in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply, the issue price of the obligation received from the United States in the exchange shall be considered for purposes of applying section 1232 to gain realized on the disposition or redemption of the obligation so received, to be the same as the issue price of the obligation which is surrendered to the United States in the ex-

change, increased by the amount of other consideration, if any, paid to the United States as part of the exchange. This subparagraph shall apply irrespective of whether there is gain or loss unrecognized on the exchange and irrespective of the fair market value, at the time of the exchange, of either the obligation surrendered to, or the obligation received from, the United States in the exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example (1). (a) A purchases in the market for $85 a marketable U.S. bond which was originally issued at its par value of $100. Three months later, A surrenders this bond to the United States in exchange solely for another $100 marketable U.S. bond which then has a fair market value of $88. He holds the new bond for 5 months and then sells it on the market for $92.

(b) On the exchange of the old bond for the new bond A realizes a gain of $3 ($88 less $85), none of which is recognized by reason of section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is $85 (the same as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be $100 (the same issue price as that of the old bond).

(d) On the sale of the new bond A realizes a gain of $7 ($92 less $85), all of which is recognized by reason of section 1002. Of this gain of $7, the entire amount is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of sec. 1232(a)(2)(B), applicable to old bond:		
Stated redemption price of old bond at maturity	$100	
Less: Issue price of old bond	100	
Original issue discount on old bond		0
(2) Ordinary income under first sentence of sec. 1232(a)(2)(B), applying sec. 1037(b)(2) to sale of new bond:		
Stated redemption price of new bond at maturity	100	
Less: Issue price of new bond under sec. 1037(b)(2)	100	
Original issue discount on new bond		0
(3) Long-term capital gain ($7 less sum of subparagraphs (1) and (2))		$7

Example (2). The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for $100. On the redemption of the new bond, A realizes a gain of $15 ($100 less $85), all of which is recognized under section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

Example (3). (a) For $1,000 B subscribes to a marketable U.S. bond which has a face value of $1,000. Thereafter, he surrenders this bond to the United States in exchange solely for a 10-year marketable $1,000 bond which at the time of exchange has a fair market value of $930, at which price such bond is initially offered to the public. Five years after the exchange, B sells the new bond for $950.

(b) On the exchange of the old bond for the new bond, B sustains a loss of $70 ($1,000 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is $1,000 (the same basis as that of the old bond).

(d) On the sale of the new bond B sustains a loss of $50 ($1,000 less $950), all of which is recognized by reason of section 1002.

Example (4). (a) The facts are the same as in example (3), except that 5 years after the exchange B sells the new bond for $1,020.

(b) On the exchange of the old bond for the new bond B sustains a loss of $70 ($1,000 less $930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in B's hands, determined under section 1031(d), is $1,000 (the same basis as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be $1,000 (the same issue price as that of the old bond).

(d) On the sale of the new bond B realizes a gain of $20 ($1,020 less $1,000), all of which is recognized by reason of section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

(6) *Other rules for applying section 1232.* To the extent not specifically affected by the provisions of section 1037(b) and subparagraphs (1) through (5) of this paragraph, any gain realized on the disposition or redemption of any obligation received from the United States in an exchange to which section 1037(a) (or so much

of section 1031 (b) or (c) as relates to section 1037(a)) applies shall be treated in the manner provided by section 1232 if the facts and circumstances relating to the acquisition and disposition or redemption of such obligation require the application of section 1232.

(c) *Holding period of obligation received in the exchange.* The holding period of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall include the period for which the obligation which was surrendered to the United States in the exchange was held by the taxpayer, but only if the obligation so surrendered was at the time of the exchange a capital asset in the hands of the taxpayer. See section 1223 and the regulations thereunder.

(d) *Basis.* The basis of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall be determined as provided in section 1031(d) and the regulations thereunder.

(e) *Effective date.* Section 1.1037 and this section shall apply only for taxable years ending after September 22, 1959.

[T.D. 6935, 32 FR 15824, Nov. 17, 1967, as amended at 36 FR 24998, Dec. 28, 1971]

§ 1.1038-1 Reacquisitions of real property in satisfaction of indebtedness.

(a) *Scope of section 1038*—(1) *General rule on gain or loss.* If a sale of real property gives rise to indebtedness to the seller which is secured by the real property which is sold, and the seller of such property reacquires such property in a taxable year beginning after September 2, 1964, in partial or full satisfaction of such indebtedness, then, except as provided in paragraphs (b) and (f) of this section, no gain or loss shall result to the seller from such reacquisition. The treatment so provided is mandatory; however, see § 1.1038-3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957. It is immaterial, for purposes of applying this subparagraph, whether the seller realized a gain or sustained a loss on the sale of the real property, or whether it can be ascertained at the time of the sale whether gain or loss occurs as a result of the sale. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale of the real property or whether at the time of reacquisition such property has depreciated or appreciated in value since the time of the original sale. Moreover, the character of the gain realized on the original sale of the property is immaterial for purposes of applying this subparagraph. The provisions of this section shall apply, except as provided in § 1.1038-2, to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034.

(2) *Sales giving rise to indebtedness*—(i) *Sale defined.* For purposes of this section, it is not necessary for title to the property to have passed to the purchaser in order to have a sale. Ordinarily, a sale of property has occurred in a transaction in which title to the property has not passed to the purchaser, if the purchaser has a contractual right to retain possession of the property so long as he performs his obligations under the contract and to obtain title to the property upon the completion of the contract. However, a sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if S contracts to sell real property to P, and if S promises to convey title to P upon the completion of all of the payments due under the contract and to allow P to obtain possession of the property after 10 percent of the purchase price has been paid, there has been a sale on the date of the contract for purposes of this section. This section shall not apply to a disposition of real property which constituted an exchange of property or was treated as a sale under section 121(d)(4) or section 1034(i); nor shall it apply to a sale of stock in a cooperative housing corporation described in section 121(d)(3) or section 1034(f).

(ii) *Secured indebtedness defined.* An indebtedness to the seller is secured by the real property for purposes of this section whenever the seller has the right to take title or possession of the property or both if there is a default with respect to such indebtedness. A sale of real property may give rise to an indebtedness to the seller although the seller is limited in his recourse to the property for payment of the indebtedness in the case of a default.

(3) *Reacquisitions in partial or full satisfaction of indebtedness*—(i) *Purpose of reacquisition.* This section applies only where the seller reacquires the real property in partial or full satisfaction of the indebtedness to him that arose from the sale of the real property and was secured by the property. That is, the reacquisition must be in furtherance of the seller's security rights in the property with respect to indebtedness to him that arose at the time of the sale. Accordingly, if the seller in reacquiring the real property does not pay consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by such property, this section shall apply to the reacquisition even though the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. If in addition to discharging the purchaser's indebtedness to him that arose from the sale the seller pays consideration in reacquiring the real property, this section shall generally apply to the reacquisition if the reacquisition and the payment of additional consideration is provided for in the original contract for the sale of the property. This section generally shall apply to a reacquisition of real property if the seller reacquires the property either when the purchaser has defaulted in his obligations under the contract or when such a default is imminent. This section generally shall not apply to a reacquisition of real property where the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale if the reacquisition and payment of additional consideration was not provided for in the original contract for the sale of the property and if the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. Thus, for example, if the purchaser is in arrears on the payment of interest or principal or has in any other way defaulted on his contract for the purchase of the property, or if the facts of the case indicate that the purchaser is unable satisfactorily to perform his obligations under the contract, and the seller reacquires the property from the purchaser in a transaction in which the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by the property, this section shall apply to the reacquisition. Additional consideration paid by the seller includes money and other property paid or transferred by the seller. Also, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of indebtedness) which arose subsequent to the original sale shall be considered as a payment by the seller of additional consideration. However, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of an indebtedness) which arose prior to or arose out of the original sale shall not be considered as a payment by the seller of additional consideration.

(ii) *Manner of reacquisition.* For purposes of applying section 1038 and this section there must be a reacquisition by the seller of the real property itself, but the manner in which the seller so reduces the property to ownership or possession, as the case may be, shall generally be immaterial. Thus, the seller may reduce the real property to ownership or possession or both, as the case may require, by agreement or by process of law. The reduction of the real property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the purchaser and abandonment to the seller. The reduction of the real property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(4) *Persons from whom real property may be reacquired.* The real property reacquired in satisfaction of the indebtedness need not be reacquired from the purchaser but may be reacquired from the purchaser's transferee or assignee, or from a trustee holding title to such property pending the purchaser's satisfaction of the terms of the contract, so long as the indebtedness that is partially or completely satisfied in the reacquisition of such property arose in the original sale of the property and was secured by the property so reacquired. In such a case, a reference in this section to the purchaser shall, where appropriate, include the purchaser's transferee or assignee. Thus, for example, this section will apply if the seller reacquires the property from a purchaser from the original purchaser and either the property is subject to, or the subsequent purchaser assumes, the liability to the seller on the indebtedness.

(5) *Reacquisitions not included.* This section shall not apply to reacquisitions of real property by mutual savings banks, domestic building and loan associations, and cooperative banks, described in section 593(a). However, for rules respecting the reacquisition of real property by such organizations, see § 1.595-1.

(b) *Amount of gain resulting from a reacquisition*—(1) *Determination of amount*—(i) *In general.* As a result of a reacquisition to which paragraph (a) of this section applies gain shall be derived by the seller to the extent that the amount of money and the fair market value of other property (other than obligations of the purchaser arising with respect to the sale) which are received by the seller, prior to such reacquisition, with respect to the sale of the property exceed the amount of the gain derived by the seller on the sale of such property which is returned as income for periods prior to the reacquisition. However, the amount of gain so determined shall in no case exceed the amount determined under paragraph (c) of this section with respect to such reacquisition.

(ii) *Amount of gain returned as income for prior periods.* For purposes of this subparagraph and paragraph (c)(1) of this section, the amount of gain on the sale of the property which is returned as income for periods prior to the reacquisition of the real property does not include any amount of income determined under paragraph (f)(2) of this section which is considered to be received at the time of the reacquisition of the property. However, the amount of gain on the sale of the property which is returned as income for such periods does include gain on the sale resulting from payments received in the taxable year in which the date of reacquisition occurs if such payments are received prior to such reacquisition. The application of this subdivision may be illustrated by the following example:

Example. In 1965 S, who uses the calendar year as the taxable year, sells to P for $10,000 real property which has an adjusted basis of $3,000. S properly elects under section 453 to report the income from the sale on the installment method. In 1965 and 1966, S receives a total of $4,000 on the contract. On May 15, 1967, S receives $1,000 on the contract. Because of P's default, S reacquires the property on August 31, 1967. The gain on the sale which is returned as income for periods prior to the reacquisition is $3,500 ($5,000 × $7,000/$10,000).

(2) *Amount of money and other property received with respect to the sale*—(i) *In general.* Amounts of money and other property received by the seller with respect to the sale of the property include payments made by the purchaser for the seller's benefit, as well as payments made and other property transferred directly to the seller. If the purchaser of the real property makes payments on a mortgage or other indebtedness to which the property is subject at the time of the sale of such property to him, or on which the seller was personally liable at the time of such sale, such payments are considered amounts received by the seller with respect to the sale. However, if after the sale the purchaser borrows money and uses the property as security for the loan, payments by the

purchaser in satisfaction of the indebtedness are not considered as amounts received by the seller with respect to the sale, although the seller does in fact receive some indirect benefit when the purchaser makes such payments.

(ii) *Payments by purchaser at time of reacquisition.* All payments made by the purchaser at the time of the reacquisition of the real property that are with respect to the original sale of the property shall be treated, for purposes of subparagraph (1) of this paragraph, by the seller as having been received prior to the reacquisition with respect to such sale. For example, if the purchaser, at the time of the reacquisition by the seller, pays money or other property to the seller in partial or complete satisfaction of the purchaser's indebtedness on the original sale, the seller shall treat such amounts as having been received prior to the reacquisition with respect to the sale.

(iii) *Interest received.* For purposes of this subparagraph and paragraph (c)(1) of this section any amounts received by the seller as interest, stated or unstated, are excluded from the computation of gain on the sale of the property and are not considered amounts of money or other property received with respect to the sale.

(iv) *Amounts received on sale of purchaser's indebtedness.* Money or other property received by the seller on the sale of the purchaser's indebtedness that arose at the time of the sale of the real property are amounts received by the seller with respect to the sale of such real property, except that the amounts so received from the sale of such indebtedness shall be reduced by the amount of money and the fair market value of other property paid or transferred by the seller, before the reacquisition of the real property, to reacquire such indebtedness. For example, if S sells real property to P for $25,000, and under the contract receives $10,000 down and a note from P for $15,000, S would receive $22,000 with respect to the sale if he were to discount the note for $12,000. If before the reacquisition of the real property S were to reacquire the discounted note for $8,000, he would receive $14,000 with respect to the sale.

(3) *Obligations of the purchaser arising with respect to the sale.* The term "obligations of the purchaser arising with respect to the sale" of the real property includes, for purposes of subparagraph (1) of this paragraph, only that indebtedness on which the purchaser is liable to the seller and which arises out of the sale of such property. Thus, the term does not include any indebtedness in respect of the property that the seller owes to a third person which the purchaser assumes, or to which the property is subject, at the time of the sale of the property to the purchaser. Nor does the term include any indebtedness on which the purchaser is liable to the seller if such indebtedness arises subsequent to the sale of such property.

(c) *Limitation upon amount of gain*—(1) *In general.* Except as provided by subparagraph (2) of this paragraph, the amount of gain on a reacquisition of real property, as determined under paragraph (b) of this section, shall in no case exceed—

(i) The amount by which the price at which the real property was sold exceeded its adjusted basis at the time of the sale, as determined under § 1.1011-1, reduced by

(ii) The amount of gain on the sale of such real property which is returned as income for periods prior to the reacquisition, and by

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property.

(2) *Cases where limitation does not apply.* The limitation provided by subparagraph (1) of this paragraph shall not apply in a case where the selling price of property is indefinite in amount and cannot be ascertained at the time of the reacquisition of such property, as, for example, where the selling price is stated as a percentage of the profits to be realized from the development of the property which is sold. Moreover, the limitation so provided shall not apply to a reacquisition of real property occurring in a taxable year beginning before September 3,

1964, to which the provisions of this section are applied pursuant to an election under § 1.1038-3.

(3) *Determination of sales price.* The price at which the real property was sold shall be, for purposes of subparagraph (1) of this paragraph, the gross sales price reduced by the selling commissions, legal fees, and other expenses incident to the sale of such property which are properly taken into account in determining gain or loss on the sale. For example, the amount of selling commissions paid by a nondealer will be deducted from the gross sales price in determining the price at which the real property was sold; on the other hand, selling commissions paid by a real estate dealer will be deducted as a business expense. Examples of other expenses incident to the sale of the property are expenses for appraisal fees, advertising expense, cost of preparing maps, recording fees, and documentary stamp taxes. Payments on indebtedness to the seller which are for interest, stated or unstated, are not included in determining the price at which the property was sold. See paragraph (b)(2)(iii) of this section.

(4) *Determination of amounts paid or transferred in connection with a reacquisition*—(i) *In general.* Amounts of money or property paid or transferred by the seller of the real property in connection with the reacquisition of such property include payments of money, or transfers of property, to persons from whom the real property is reacquired as well as to other persons. Payments or transfers in connection with the reacquisition of the property do not include money or property paid or transferred by the seller to reacquire obligations of the purchaser to the seller which were received by the seller with respect to the sale of the property or which arose subsequent to the sale. Amounts of money or property paid or transferred by the seller in connection with the reacquisition of the property include payments or transfers for such items as court costs and fees for services of an attorney, master, trustee, or auctioneer, or for publication, acquiring title, clearing liens, or filing and recording.

(ii) *Assumption of indebtedness.* The assumption by the seller, upon reacquisition of the real property, of any indebtedness to another person which at such time is secured by such property will be considered a payment of money by the seller in connection with the reacquisition. Also, if at the time of reacquisition such property is subject to an indebtedness which is not an indebtedness of the purchaser to the seller, the seller shall be considered to have paid money, in an amount equal to such indebtedness, in connection with the reacquisition of the property. Thus, for example, if at the time of the sale the purchaser executes in connection with the sale a first mortgage to a bank and a second mortgage to the seller and at the time of reacquisition the seller reacquires the property subject to the first mortgage which he does not assume, the seller will be considered to have paid money, in an amount equal to the unpaid amount of the first mortgage, in connection with the reacquisition.

(d) *Character of gain resulting from a reacquisition.* Paragraphs (b) and (c) of this section set forth the extent to which gain shall be derived from a reacquisition to which paragraph (a) of this section applies, but the rule provided by section 1038 and this section do not affect the character of the gain so derived. The character of the gain resulting from such a reacquisition is determined on the basis of whether the gain on the original sale was returned on the installment method or, if not, on the basis of whether title to the real property was transferred to the purchaser; and, if title was transferred to the purchaser in a deferred-payment sale, whether the reconveyance of the property to the seller was voluntary. For example, if the gain on the original sale of the reacquired property was returned on the installment method, the character of the gain on reacquisition by the seller shall be determined in accordance with the rules provided in paragraph (a) of § 1.453-9. If the original sale was not on the installment method but was a deferred-payment sale, as described in § 1.453-6(a), where title to the real property was transferred to the purchaser and the seller accepts a voluntary reconveyance of the property, the gain on the reacquisition shall be ordinary income; however, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain resulting from the reacquisition is capital gain subject to the provisions of subchapter P of chapter 1 of the Code.

(e) *Recognition of gain.* The entire amount of the gain determined under paragraphs (b) and (c) of this section with respect to a reacquisition to which paragraph (a) of this section applies shall be recognized notwithstanding any other provisions of subtitle A (relating to income taxes) of the Code.

(f) *Special rules applicable to worthless indebtedness*—(1) *Worthlessness resulting from reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which paragraph (a) of this section applies. Accordingly, no deduction for a bad debt and no charge against a reserve for bad debts shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property.

(2) *Indebtedness treated as worthless prior to reacquisition*—(i) *Prior taxable years.* If for any taxable year ending before the taxable year in which occurs a reacquisition of real property to which paragraph (a) of this section applies the seller of such property has treated any indebtedness of the purchaser which is secured by such property as having become worthless or partially worthless by taking a bad debt deduction under section 166(a), he shall be considered as receiving, at the time of such reacquisition, income in an amount equal to the amount of such indebtedness previously treated by him as having become worthless. The amount so treated as income received shall be treated as a recovery of a bad debt previously deducted as worthless or partially worthless. Accordingly, the amount of such income shall be excluded from gross income, as provided in § 1.111-1, to the extent of the "recovery exclusion" with respect to such item. For purposes of § 1.111-1, if the indebtedness was treated as partially worthless in a prior taxable year, the amount treated under this subparagraph as a recovery shall be considered to be with respect to the part of the indebtedness that was previously deducted as worthless. The seller shall not be considered to have treated an indebtedness as worthless in any taxable year for which he took the standard deduction under section 141 or paid the tax imposed by section 3 if a deduction in respect of such indebtedness was not allowed in determining adjusted gross income for such year under section 62.

(ii) *Current taxable year.* No deduction shall be allowed under section 166 (a), for the taxable year in which occurs a reacquisition of real property to which paragraph (a) of this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(3) *Basis adjustment.* The basis of any indebtedness described in subparagraph (2)(i) of this paragraph shall be increased (as of the date of the reacquisition) by an amount equal to the amount which, under such subparagraph of this paragraph, is treated as income received by the seller with respect to such indebtedness, but only to the extent the amount so treated as received is not excluded from gross income by reason of the application of § 1.111-1.

(g) *Rules for determining gain or loss on disposition of reacquired property*—(1) *Basis of reacquired real property.* The basis of any real property acquired in a reacquisition to which paragraph (a) of this section applies shall be the sum of the following amounts, determined as of the date of such reacquisition:

(i) The amount of the adjusted basis, determined under sections 453 and 1011, and the regulations thereunder, of all indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such property, including any increase by reason of paragraph (f)(3) of this section,

(ii) The amount of gain determined under paragraphs (b) and (c) of this section with respect to such reacquisition, and

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property, determined as provided in paragraph (c) of this section even though such paragraph does not apply to the reacquisition.

(2) *Basis of undischarged indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property described in subparagraph (1) of this paragraph, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero. Therefore, to the extent not discharged upon the reacquisition of the real property, indebtedness on the original obligation of the purchaser, a substituted obligation of the purchaser, a deficiency judgment entered in a court of law into which the purchaser's obligation has merged, or any other obligation of the purchaser to the seller, shall be zero if such indebtedness constitutes an indebtedness to the seller which was secured by such property.

(3) *Holding period of reacquired property.* Since the reacquisition described in subparagraph (1) of this paragraph is in a sense considered a nullification of the original sale of the real property, for purposes of determining gain or loss on a disposition of such property after its reacquisition the period for which the seller has held the real property at the time of such disposition shall include the period for which such property is held by him prior to the original sale. However, the holding period shall not include the period of time commencing with the date following the date on which the property is originally sold to the purchaser and ending with the date on which the property is reacquired by the seller. The period for which the property was held by the seller prior to the original sale shall be determined as provided in § 1.1223-1. For example, if under paragraph (a) of § 1.1223-1 real property, which was acquired as the result of an involuntary conversion, has been held for five months on January 1, 1965, the date of its sale, and such property is reacquired on July 2, 1965, and resold on July 3, 1965, the seller will be considered to have held such property for five months and one day for purposes of this subparagraph.

(h) *Illustrations.* The application of this section may be illustrated by the following examples in which it is assumed that the reacquisition is in satisfaction of secured indebtedness arising out of the sale of the real property:

Example (1). (a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the second $10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $110.

(b) The gain derived by S on the reacquisition of the property is $6, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$30
Less: Gain returned by S as income for periods prior to the reacquisition ($30 × [($100 − $20)/$100])		24
Gain before application of limitation		6
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$20	
Gain returned by S as income for periods prior to the reacquisition	24	
Amount of money paid by S in connection with the reacquisition	5	49
Limitation on amount of gain		51
Gain resulting from the reacquisition of the property		6

(c) The basis of the reacquired real property at the date of the reacquisition is $25, determined as follows:

Adjusted basis of P's indebtedness to S ($70 – [$70 × $80/$100])	$14
Gain resulting from the reacquisition of the property	6
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	25

Example (2). (a) The facts are the same as in example (1) except that S purchased the property for $80.

(b) The gain derived by S on the reacquisition of the property is $9, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$30
Less: Gain returned by S as income for periods prior to the reacquisition ($30 × [($100 – $80)/$100])		6
Gain before application of limitation		24
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount of money paid by S in connection with the reacquisition	5	91
Limitation on amount of gain		9
Gain resulting from the reacquisition of the property		9

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S ($70 – [$70 × $20/$100])	$56
Gain resulting from the reacquisition of the property	9
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	

Example (3). (a) S purchases real property for $70 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the first $10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $50.

(b) The gain derived by S on the reacquisition of the property is $14, determined as follows:

Gain before application of limitation:		
Money with respect to the sale received by S prior to the reacquisition		$20
Less: Gain returned by S as income for periods prior to the reacquisition ($20 × [($100 – $70)/$100])		6
Gain before application of limitation		14
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at time of sale	$70	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount paid by S in connection with the reacquisition	5	81
Limitation on amount of gain		19
Gain resulting from the reacquisition of the property		14

(c) The basis of the reacquired real property at the date of the reacquisition is $75, determined as follows:

Adjusted basis of P's indebtedness to S ($80 – [$80 × $30/$100])	$56
Gain resulting from the reacquisition of the property	14
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	75

Example (4). (a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report gain on the installment method. After the second $10 annual payment P defaults and S accepts from P in complete satisfaction of the indebtedness a voluntary reconveyance of the property plus cash in the amount of $20. S does not pay any amount in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $30.

(b) The gain derived by S on the reacquisition of the property is $10, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition ($30 + $20)		$50
Less: Gain returned by S as income for periods prior to the reacquisition ($50 × [($100 – $20)/$100])		40
Gain before application of limitation		10
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at time of sale	$20	
Gain returned by S as income for periods prior to the reacquisition	40	60

Limitation on amount of gain	$40
Gain resulting from the reacquisition of the property	10

(c) The basis of the reacquired real property at the date of the reacquisition is $20, determined as follows:

Adjusted basis of P's indebtedness to S ($50 – [$50 × $80/$100])	$10
Gain resulting from the reacquisition of the property	10
Basis of reacquired property	20

Example (5). (a) S purchases real property for $80 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. At the time of sale P's note has a fair market value of $90. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale. After the third $10 annual payment P defaults and S forecloses. Under the foreclosure sale S bids in the property at $70, cancels P's obligation of $60, and pays $10 to P. There are no other amounts paid by S in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $70.

(b) The gain derived by S on the reacquisition of the property is $0, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition		$40
Less: Gain returned by S as income for periods prior to the reacquisition ([$10 + $90] – $80)		20
Gain before application of limitation		20
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	20	
Amount of money paid by S in connection with the reacquisition	10	110
Limitation on amount of gain (not to be less than zero)		0
Gain resulting from the reacquisition of the property		0

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S (face value at time of reacquisition)	$60
Gain resulting from the reacquisition of the property	0
Amount of money paid by S in connection with the reacquisition	10
Basis of reacquired property	70

[T.D. 6916, 32 FR 5925, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038-2 Reacquisition and resale of property used as a principal residence.

(a) *Application of special rules*—(1) *In general.* If paragraph (a) of § 1.1038-1 applies to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034, the provisions of § 1.1038-1 (other than paragraph (a) thereof) shall not, and this section shall, apply to the reacquisition of such property if the property is resold by the seller within one year after the date of the reacquisition. For purposes of this section an election under section 121 shall be considered to be in effect with respect to the sale of the property if, at the close of the last day for making such an election under section 121(c) with respect to such sale, an election under section 121 has been made and not revoked. Thus, a taxpayer who properly elects, subsequent to the reacquisition, to have section 121 apply to a sale of his residence may be eligible for the treatment provided in this section. The treatment provided by this section is mandatory; however, see § 1.1038-3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957.

(2) *Sale and resale treated as one transaction.* In the case of a reacquisition to which this section applies, the resale of the reacquired property shall be treated, for purposes of applying sections 121 and 1034, as part of the transaction constituting the original sale of such property. In effect, the reacquisition is generally disregarded pursuant to this section and, for purposes of applying sections 121 and 1034, the resale of the property is considered to constitute a sale of such property occurring on the date of the original sale of such property.

(b) *Transactions not included.* (1) If with respect to the original sale of the property there was no nonrecognition of gain under section 1034 and an election under section 121 is not in effect, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition. Thus, for example, if in the case of a taxpayer not entitled to the benefit of section 121 there is no gain on the original sale of the property, the provisions of § 1.1038-1, and not this section, shall apply even though a redetermination of gain under this section would result in the nonrecognition of gain on the sale under section 1034. Also, if in the case of such a taxpayer there was gain on the original sale of the property but after the application of section 1034 all of such gain was recognized, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition.

(2) If the original sale of the property was not eligible for the treatment provided by section 121 and section 1034, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition of the property even though the resale of such property is eligible for the treatment provided by either or both of sections 121 and 1034.

(c) *Redetermination of gain required*—(1) *Sale of old residence.* The amount of gain excluded under section 121 on the sale of the property and the amount of gain recognized under section 1034 on the sale of the property shall be redetermined under this section by recomputing the adjusted sales price and the adjusted basis of the property, and any adjustments resulting from the redetermination of the gain on the sale of such property shall be reflected in the income of the seller for his taxable year in which the resale of the property occurs.

(2) *Sale of new residence.* If gain was not recognized under section 1034 on the original sale of the property, the adjusted basis of the new residence shall be redetermined under this section. If the new residence has been sold, the amount of gain returned on such sale of the new residence which is affected by the redetermination of the recognized gain on the sale of the old residence shall be redetermined under this section, and any adjustments resulting from the redetermination of the gain on the sale of the new residence shall be reflected in income of the seller for his taxable year in which the resale of the old residence occurs.

(d) *Redetermination of adjusted sales price.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted sales price of the reacquired real property shall be redetermined by taking into account both the sale and the resale of the property and shall be—

(1) The amount realized, which for purposes of section 1001 shall be—

(i) The amount realized on the resale of the property, as determined under paragraph (b)(4) of § 1.1034-1, plus

(ii) The amount realized on the original sale of the property, determined as provided in paragraph (b)(4) of § 1.1034-1, less that portion of any obligations of the purchaser arising with respect to such sale which at the time of reacquisition is secured by such property and is unpaid, less

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property,

reduced by

(2) The total of the fixing-up expenses (as defined in par. (b)(6) of § 1.1034-1) incurred for work performed on such real property to assist in both its original sale and its resale.

For purposes of applying paragraph (b)(6) of § 1.1034-1, there shall be two 90-day periods, the first ending on the day on which the contract to sell is entered into in connection with the original sale of the property, and the second ending on the day on which the contract to sell is entered into in connection with the resale of the property. There shall also be two 30-day periods for such purposes, the first ending on the 30th day after the date of the original sale, and the second ending on the 30th day after the date of the resale. For determination of the obligations of the purchaser arising with respect to the original sale of the property, see paragraph (b)(3) of § 1.1038-1. For determination of amounts paid or transferred by the seller in connection with the reacquisition of the property, see paragraph (c)(4) of § 1.1038-1.

(e) *Determination of adjusted basis at time of resale.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted basis of the reacquired real property at the time of its resale shall be—

(1) The sum of—

(i) The adjusted basis of such property at the time of the original sale, with proper adjustment under section 1016(a) in respect of such property for the period occurring after the reacquisition of such property, and

(ii) Any indebtedness of the purchaser to the seller which arose subsequent to the original sale of such property and which at the time of reacquisition was secured by such property,

reduced by

(2) Any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by the reacquired real property and which, for any taxable year ending before the taxable year in which occurs the reacquisition to the seller which was secured by the seller as having become worthless or partially worthless by taking a bad debt deduction under section 166(a).

The reduction under the preceding sentence by reason of having treated indebtedness as worthless or partially worthless shall not exceed the amount by which there would be an increase in the basis of such indebtedness under paragraph (f)(3) of § 1.1038-1 if section 1038(d) had been applicable to the reacquisition of such property.

(f) *Treatment of indebtedness secured by the property*—(1) *Year of reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which this section applies. Accordingly, no deduction for a bad debt shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property. In addition, no deduction shall be allowed, for the taxable year in which occurs a reacquisition of real property to which this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(2) *Prior taxable years.* For reduction of the basis of the real property for indebtedness treated as worthless or partially worthless for taxable years ending before the taxable year in which occurs the reacquisition, see paragraph (e) of this section.

(3) *Basis of indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero.

(g) *Date of sale.* Since the resale of the property, by being treated as part of the transaction constituting the original sale of the property, is treated as having occurred on the date of the original sale, in determining whether any of the time requirements of section 121 or section 1034 are satisfied for purposes of this section the date of the original sale is used, except to the extent provided in paragraph (d)(2) of this section.

(h) *Illustrations.* The application of this section may be illustrated by the following examples:

Example (1). (a) On June 30, 1964, S, a single individual over 65 years of age, sells his principal residence to P for $25,000, the property not being mortgaged at the time of sale. S properly elects to apply the provisions of section 121 to the sale. Under the contract, P pays $5,000 down and executes a note for $20,000 with stated interest at 6 percent, the principal being payable in installments of $5,000 each on January 1 of each year and the note being secured by the real property which is sold. At the time of sale P's note has a fair market value of $20,000. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale, title to the property being transferred to P at the time of sale. S uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. After making two annual payments of $5,000 each on the note, P defaults on the contract, and on March 1, 1967, S reacquires the real property in full satisfaction of P's indebtedness, title to the property being voluntarily reconveyed to S. On November 1, 1967, S sells the property to T for $35,000. The assumption is made that no fixing-up expenses are incurred for work performed on the principal residence in order to assist in the sale of the property in 1964 or in the resale of the property in 1967. At the time of sale in 1964 the property has an adjusted basis of $15,000. S does not treat any indebtedness with respect to the sale in 1964 as being worthless or partially worthless or make any capital expenditures with respect to the property after such sale. In his return for 1964, S includes in income $2,000 capital gain from the sale of his residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Adjusted sales price:		
$5,000 + $20,000	$25,000	
$15,000 + $35,000		$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under sec. 121:		
$10,000 × $20,000/$25,000	8,000	
$35,000 × $20,000/$50,000		14,000
Gain included in income after applying sec. 121:		
$10,000 − $8,000	2,000	
$35,000 − $14,000		21,000

(c) S is required to show the additional inclusion of $19,000 capital gain ($21,000 − $2,000) in income on his return for 1967.

Example (*2*). (a) The facts are the same as in example (1) except that on April 1, 1965, S purchases a new residence at a cost of $30,000 and qualifies for the nonrecognition of gain under section 1034 in respect of the sale of his principal residence on June 30, 1964. In his return for 1964, S does not include any capital gain in income as a result of the sale of the old residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Application of sec. 121 (see example (1)):		
Adjusted sales price	$25,000	$50,000
Less: Adjusted basis of property at time of sale	$15,000	$15,000
Gain on sale	10,000	35,000
Gain excluded from income under sec. 121	8,000	14,000
Gain not excluded from income under sec. 121	2,000	21,000
Application of sec. 1034: Adjusted sales price:		
$25,000 − $8,000	17,000	
$50,000 − $14,000		36,000
Less: Cost of new residence	30,000	30,000
Gain recognized under sec. 1034 on sale of old residence	0	6,000
Gain not recognized under sec. 1034 on sale of old residence:		
($10,000 − [$8,000 + $0])	2,000	
($35,000 − [$14,000 + $6,000])		15,000
Adjusted basis of new residence on April 1, 1965:		
$30,000 − $2,000	28,000	
$30,000 − $15,000		15,000

(c) The $6,000 of capital gain on the sale of the old residence is required to be included in income on the return for 1967. The adjusted basis on April 1, 1965, for determining gain on a sale or exchange of the new residence at any time on or after that date is $15,000, after taking into account the reacquisition and resale of the old residence.

Example (*3*). The facts are the same as in example (2) except that S sells the new residence on June 20, 1965, for $40,000 and includes $12,000 of capital gain ($40,000 − $28,000) on its sale in his income on the return for 1965. S is required to include the additional capital gain of $13,000 ([$40,000 − $15,000] − $12,000) on the sale of the new residence in his income on the return for 1967. For this purpose, the assumption is also made that there are no additional adjustments to the basis of the new residence after April 1, 1965.

[T.D. 6916, 32 FR 5929, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038–3 Election to have section 1038 apply for taxable years beginning after December 31, 1957.

(a) *In general.* If an election is made in the manner provided by paragraph (b) of this section, the applicable provisions of §§ 1.1038–1 and 1.1038–2 shall apply to all reacquisitions of real property occurring in each and every taxable year beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law. The election so made shall apply to all taxable years beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law and shall apply to every reacquisition occurring in such taxable years. The fact that the assessment of a deficiency, or the credit or refund of an overpayment, is prevented for any other taxable year or years affected by the election will not prohibit the making of an election under this section. For example, if an individual who uses the calendar year as the taxable year were to sell in 1960 real property used as his principal residence in respect of the sale of which gain is not recognized under section 1034, and if such property were reacquired by the seller in 1962 and resold within 1 year, he would be permitted to make an election under this section with respect to such reacquisition even though on September 2, 1964, the period of limitations on assessment or refund has run for 1960. An election under this section shall be deemed a consent to the application of the provisions of this section.

(b) *Time and manner of making election*—(1) *In general.* (i) An election to have the provisions of § 1.1038-2 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which the resale of such real property occurs. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(ii) An election to have the provisions of § 1.1038-1 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which such reacquisitions occur. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(iii) If the facts are such that § 1.1038-2 applies to a reacquisition of property except that the reacquisition occurs in a taxable year beginning after December 31, 1957, and before September 3, 1964, an election may not be made under this paragraph to have the provisions of § 1.1038-1 apply to such reacquisition.

(iv) Once made, an election under this paragraph may not be revoked after September 3, 1965. To any return, amended return, or claim for refund filed under this subparagraph there shall be attached the statement described in subparagraph (2) of this paragraph.

(2) *Statement to be attached.* The statement described in subparagraph (1) of this paragraph shall indicate—

(i) The name, address and account number of the taxpayer, and the fact that the taxpayer is electing to have the provisions of section 1038 apply to the reacquisitions of real property,

(ii) The taxable years in which the reacquisitions of property occur and any other taxable year or years the tax for which is affected by the application of section 1038 to such reacquisitions,

(iii) The office of the district director where the return or returns for such taxable year or years were or will be filed,

(iv) The dates on which such return or returns were filed and on which the tax for such taxable year or years was paid,

(v) The type of real property reacquired, the terms under which such property was sold and reacquired, and an indication of whether the taxpayer is applying the provisions of § 1.1038-2 to the reacquisition of such property,

(vi) If § 1.1038-2 is being applied to the reacquisition, the terms under which the old residence was resold and, if applicable, the terms under which the new residence was sold, and

(vii) The office where, and the date when, the election to apply section 121 in respect to any sale of such property was or will be made.

(3) *Place for filing.* Any claim for refund, amended return, or statement, filed under this paragraph in respect of any taxable year, whether the taxable year in which occurs the reacquisition of property or the taxable year in which occurs the resale of the old residence, shall be filed in the office of the district director in which the return for such taxable year was or will be filed.

(c) *Extension of period of limitations on assessment or refund*—(1) *Assessment of tax.* If an election is properly made under paragraph (b) of this section and the assessment of a deficiency for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a deficiency for such taxable years may be assessed shall, to the extent such deficiency is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(2) *Refund of tax.* If an election is properly made under paragraph (b) of this section and the credit or refund of any overpayment for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a claim for credit or refund of an overpayment for such taxable years may be filed shall, to the extent such overpayment is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(d) *Payment of interest for period prior to September 2, 1964.* No interest shall be payable with respect to any deficiency attributable to the application of the provisions of section 1038, and no interest shall be allowed with respect to any credit or refund of any overpayment attributable to the application of such section, for any period prior to September 2, 1964. See section 2(c)(3) of the Act of September 2, 1964 (Public Law 88-750, 78 Stat. 856).

[T.D. 6916, 32 FR 5930, Apr. 13, 1967]

§ 1.1039-1 Certain sales of low-income housing projects.

(a) *Nonrecognition of gain.* Section 1039 provides rules under which the taxpayer may elect not to recognize gain in certain cases where a qualified housing project is sold or disposed of after October 9, 1969, in an approved disposition and another such qualified housing project or projects (referred to as the "replacement project") is acquired, constructed, or reconstructed within a specified reinvestment period. If the requirements of section 1039 are met, and if the taxpayer makes an election in accordance with the provisions of paragraph (b)(4) of this section, then the gain realized upon the sale or disposition is recognized only to the extent that the net amount realized on such sale or disposition exceeds the cost of the replacement project. However, notwithstanding section 1039, gain may be recognized by reason of the application of section 1245 or 1250 to the sale or disposition. (See § 1.1245-6(b) and § 1.1250-3(h). The terms "qualified housing project," "approved disposition," "reinvestment period," and "net amount realized" are defined in paragraph (c) of this section.

(b) *Rules of application*—(1) *In general.* The election under section 1039(a) may be made only by the taxpayer owning the qualified housing project disposed of. Thus, if the qualified housing project disposed of is owned by a partnership, the partnership must make the election. (See section 703(b).) Similarly, if the qualified housing project disposed of is owned by a corporation or trust, the corporation or trust must make the election. In addition, the reinvestment of the taxpayer must be in such a manner that the taxpayer would be entitled to a deduction for depreciation on the replacement project. Thus, if the qualified housing project disposed of is owned by individual A, the purchase by A of stock in a corporation owning or constructing such a project or of an interest in a partnership owning or constructing such a project will not be considered as the purchase or construction by A of such a project.

(2) *Special rules.* (i) The cost of a replacement project acquired before the approved disposition of a qualified housing project shall be taken into account under section 1039 only if such property is held by the taxpayer on the date of the approved disposition.

(ii) Except as provided in section 1039 (d), no property acquired by the taxpayer shall be taken into account for purposes of section 1039(a)(2) unless the unadjusted basis of such property is its cost within the meaning of section 1012. For example, if a qualified housing project is acquired in an exchange under section 1031, relating to exchange of property held for productive use or investment, such property will not be taken into account under section 1039(a)(2) because its basis is determined by reference to the basis of the property exchanged. (See section 1031(d).)

(3) *Cost of replacement project.* The taxpayer's cost for the replacement project includes only amounts properly treated as capital expenditures by the taxpayer that are attributable to acquisition, construction, or reconstruction made within the reinvestment period (as defined in paragraph (c)(4) of this section). See section 263 for rules as to what constitutes capital expenditures. Thus, assume that a calendar year taxpayer realizes gain in 1970 upon the approved disposition of a qualified housing project occurring on January 1, 1970. If the taxpayer had begun construction of another qualified housing project on January 1, 1969, and completes such construction on June 1, 1972, only that portion of the cost attributable to the period before January 1, 1972, constitutes the cost of the replacement project for purposes of section 1039. For purposes of determining the cost of a replacement project attributable to a particular period, the total cost of the project may be allocated to such period on the basis of the portion of the total project actually constructed during such period.

(4) *Election.* (i) An election not to recognize the gain realized upon an approved disposition of a qualified housing project to the extent provided in section 1039(a) may be made by attaching a statement to the income tax return filed for the first taxable year in which any portion of the gain on such disposition is realized. Such a statement shall contain the information required by subdivision (iii) of this subparagraph. If the taxpayer does not file such a statement for the first taxable year in which any portion of the gain is realized, but fails to report a portion of the gain realized upon the approved disposition as income for such year or for any subsequent taxable year, then an election shall be deemed to be made under section 1039 (a) with respect to that portion of the gain not reported as income.

(ii) An election may be made under section 1039(a) even though the replacement project has not been acquired or constructed at the time of election. However, if an election has been made and (*a*) a replacement project is not constructed, reconstructed, or acquired, (*b*) the cost of the replacement project is lower than the net amount realized from the approved disposition, or (*c*) a decision is made not to construct, reconstruct, or acquire a replacement project, then the tax liability for the year or years for which the election was made shall be recomputed and an amended return filed. An election may be made even though the taxpayer has filed his return and recognized gain upon the disposition provided that the period of limitation on filing claims for credit or refund prescribed by section 6511 has not expired. In such case, a statement containing the information required by subdivision (iii) of this subparagraph should be filed together with a claim for credit or refund for the taxable year or years in which gain was recognized.

(iii) The statement referred to in subdivisions (i) and (ii) of this subparagraph shall contain the following information:

(*a*) The date of the approved disposition;

(*b*) If a replacement project has been acquired, the date of acquisition and cost of the project;

(*c*) If a replacement project has been constructed or reconstructed by or for the taxpayer, the date construction was begun, the date construction was completed, and the percentage of construction completed within the reinvestment period;

(*d*) If no replacement project has been constructed, reconstructed, or acquired prior to the time of filing of the statement, the estimated cost of such construction, reconstruction, or acquisition;

(*e*) The adjusted basis of the project disposed of; and

(*f*) The amount realized upon the approved disposition and a description of the expenses directly connected with the disposition and the taxes (other than income taxes) attributable to the disposition.

(c) *Definitions*—(1) *General.* The definitions contained in subparagraphs (2) through (5) of this paragraph shall apply for purposes of this section.

(2) *Qualified housing project.* The term "qualified housing project" means a rental or cooperative housing project for lower income families that has been constructed, reconstructed, or rehabilitated pursuant to a mortgage which is insured under section 221(d)(3) or 236 of the National Housing Act, provided that with respect to the housing project disposed of and the replacement project constructed, reconstructed, or acquired, the owner of the project at the time of the approved disposition and prior to the close of the reinvestment period is, under such sections or regulations issued thereunder,

(i) Limited as to rate of return on his investment in the project, and

(ii) Limited as to rentals or occupancy charges for units in the project.

If the owner of the project is organized and operated as a nonprofit cooperative or other nonprofit organization, then such owner shall be considered to meet the requirement of subdivision (i) of this subparagraph.

(3) *Approved disposition.* The term "approved disposition" means a sale or other disposition of a qualified housing project to the tenants or occupants of units in such project, or to a nonprofit cooperative or other nonprofit organization formed and operated solely for the benefit of such tenants or occupants, provided that it is approved by the Secretary of Housing and Urban Development or his delegate under section 221 (d)(3) or 236 of the National Housing Act or regulations issued under such sections. Evidence of such approval should be attached to the tax return or statement in which the election under section 1039 is made.

(4) *Reinvestment period.* (i) The term "reinvestment period" means the period beginning 1 year before the date of the disposition and ending 1 year after the close of the first taxable year in which any part of the gain from such disposition is realized, or at such later date as may be designated pursuant to an application made by the taxpayer. Such application shall be made before the expiration of 1 year after the close of the first taxable year in which any part of the gain from such disposition is realized, unless the taxpayer can show to the satisfaction of the district director that—

(*a*) Reasonable cause exists for not having filed the application within the required period, and

(*b*) The filing of such application was made within a reasonable time after the expiration of the required period.

The application shall contain all the information required by paragraph (b)(4) of this section and shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the approved disposition is realized.

(ii) Ordinarily, requests for extension of the reinvestment period will not be granted until near the end of such period and any extension will usually be limited to a period not exceeding 1 year. Although granting of an extension depends upon the facts and circumstances of a particular case, if a predominant portion of the construction of the replacement project has been completed or is reasonably expected to be completed within the reinvestment period (determined without regard to any extension thereof), an extension of the reinvestment period will ordinarily be granted. The fact that there is a scarcity of replacement property for acquisition will not be considered sufficient grounds for granting an extension.

(5) *Net amount realized.* (i) The "net amount realized" from the approved disposition of a qualified housing project is the amount realized from such disposition, reduced by—

(*a*) The expenses paid or incurred by the taxpayer which are directly connected with the approved disposition, and

(*b*) The amount of taxes (other than income taxes) paid or incurred by the taxpayer which are attributable to the approved disposition.

(ii) Examples of expenses directly connected with an approved disposition of a qualified housing project include amounts paid for sales or other commissions, advertising, and for the preparation of a deed or other legal services in connection with the disposition. An amount paid for a repair to the building will be considered as an expense directly connected with the approved disposition under subdivision (i)(*a*) of this subparagraph only if such repair is required as a condition of sale, or is required by the Secretary of Housing and Urban Development or his delegate as a condition of approval of the disposition.

(iii) Examples of taxes that are attributable to the approved disposition include local property transfer taxes and stamp taxes. A local real property tax is not so attributable.

(d) *Basis and holding period of replacement project*—(1) *Basis.* If the taxpayer makes an election under section 1039, the basis of the replacement housing project shall be its cost (including costs incurred subsequent to the reinvestment period) reduced by the amount of gain not recognized under section 1039 (a). If the replacement consists of more than one housing project, the basis determined under this subparagraph shall be allocated to the properties in proportion to their respective costs.

(2) *Holding period.* The holding period of the replacement housing project shall begin on the date the taxpayer acquires such project, that is, on the date the taxpayer first acquires possession or control of such project and bears the burdens and enjoys the benefits of ownership of the replacement project. (For special rule regarding the holding period of property for purposes of section 1250, see section 1250(e)(4).)

(e) *Assessment of deficiencies*—(1) *Deficiency attributable to gain.* If a taxpayer makes an election under section 1039(a) with respect to an approved disposition, any deficiency attributable to the gain on such disposition, for any taxable year in which any part of such gain is realized, may be assessed at any time before the expiration of 3 years after the date the district director or director of the regional service center with whom the return for such year has been filed is notified by the taxpayer of the acquisition or the completion of construction or reconstruction of the replacement qualified housing project or of the failure to acquire, construct, or reconstruct a replacement qualified housing project, as the case may be. Such a deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain the information required by paragraph (b)(4)(iii) of this section. Such notification shall be attached to the return filed for the taxable year or years in which the replacement occurs, or in which the period for the replacement expires, and a copy of such notification shall be filed with the district director or director of regional service center with whom the election under section 1039(a) was required to be filed, if the return is not filed with such director.

(2) *Deficiency attributable to election.* If gain upon an approved disposition is realized in two (or more) taxable years, and the replacement qualified housing project was acquired, constructed, or reconstructed before the

beginning of the last such year, any deficiency, for any taxable year before such last year, which is attributable to an election by the taxpayer under section 1039(a) may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment. Thus, if gain upon an approved disposition is realized in 1971 and 1975, and if a replacement project is purchased in 1971, any deficiency for 1971 may be assessed within the period for assessing a deficiency for 1975.

[T.D. 7191, 37 FR 12951, June 30, 1972; 37 FR 14385, July 20, 1972, as amended by T.D. 7400, 41 FR 5101, Feb. 4, 1976]

SPECIAL RULES

§ 1.1051-1 Basis of property acquired during affiliation.

(a)(1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

(b) The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502 of the Internal Revenue Code of 1954 or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Act of 1938 (52 Stat. 447), 1936 (49 Stat. 1652), 1934 (48 Stat. 683), 1932 (47 Stat. 169), or 1928 (45 Stat. 791), the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§ 1.1052-1 Basis of property established by Revenue Act of 1932.

Section 1052(a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932 (47 Stat. 169), was prescribed by section 113(a) (6), (7), or (9) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1932. For the rules applicable in determining the basis of stocks or securities under section 113(a)(9) of the Revenue Act of 1932 in case of certain distributions after December 31, 1923, and in any taxable year beginning before January 1, 1934, see 26 CFR (1939) 39.113 (a)(12)-1 (Regulations 118).

§ 1.1052-2 Basis of property established by Revenue Act of 1934.

Section 1052(b) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 (48 Stat. 683) was prescribed by section 113(a) (6), (7), or (8) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning before January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b)(5) of the Internal Revenue Code of 1939 but which is described in section 112(b)(5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§ 1.1052-3 Basis of property established by the Internal Revenue Code of 1939.

Section 1052(c) provides that if property was acquired after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied and the basis thereof was prescribed by section 113(a)(6), (7), (8), (13), (15), (18), (19) or (23) of such Code, then for purposes of subtitle A of the Internal Revenue Code of 1954, the basis shall be the same as the basis prescribed in the Internal Revenue Code of 1939. In such cases, see section 113(a) of the Internal Revenue Code of 1939 and the regulations thereunder.

§ 1.1053-1 Property acquired before March 1, 1913.

(a) *Basis for determining gain.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining gain is the cost or other basis, adjusted as provided in section 1016 and other applicable provisions of chapter 1 of the Code, or its fair market value as of March 1, 1913, whichever is greater.

(b) *Basis for determining loss.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining loss is the basis determined in accordance with part II (section 1011 and following), subchapter O, chapter 1 of the Code, or other applicable provisions of chapter 1 of the Code, without reference to the fair market value as of March 1, 1913.

(c) *Example.* The application of paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. (i) On March 1, 1908, a taxpayer purchased for $100,000, property having a useful life of 50 years. Assuming that there were no capital improvements to the property, the depreciation sustained on the property before March 1, 1913, was $10,000 (5 years @ $2,000), so that the original cost adjusted, as of March 1, 1913, for depreciation sustained prior to that date is $90,000. On that date the property had a fair market value of $94,500 with a remaining life of 45 years.

(ii) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1954, the basis of the property is the fair market value of $94,500 as of March 1, 1913, adjusted for depreciation allowed or allowable after February 28, 1913, computed on $94,500. Thus, the substituted basis, $94,500, is reduced by the depreciation adjustment from March 1, 1913, to February 28, 1954, in the aggregate of $86,100 (41 years @ $2,100), leaving an adjusted basis for determining gain of $8,400 ($94,500 less $86,100).

(iii) For the purpose of determining loss from the sale or other disposition of such property on March 1, 1954, the basis of the property is its cost, adjusted for depreciation sustained before March 1, 1913, computed on cost, and the amount of depreciation allowed or allowable after February 28, 1913, computed on the fair market value of $94,500 as of March 1, 1913. In this example, the amount of depreciation sustained before March 1, 1913, is $10,000 and the amount of depreciation determined for the period after February 28, 1913, is $86,100. Therefore, the aggregate amount of depreciation for which the cost ($100,000) should be adjusted is $96,100 ($10,000 plus $86,100), and the adjusted basis for determining loss on March 1, 1954, is $3,900 ($100,000 less $96,100).

(d) *Fair market value.* The determination of the fair market value of property on March 1, 1913, is generally a question of fact and shall be established by competent evidence. In determining the fair market value of stock or other securities, due regard shall be given to the fair market value of the corporate assets as of such date, and other pertinent factors. In the case of property traded in on public exchanges, actual sales on or near the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced-sale price, or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time. In such a case the value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in each case.

§ 1.1054-1 Certain stock of Federal National Mortgage Association.

(a) *In general.* The basis in the hands of the initial holder of a share of stock which is issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., sec. 1718) in a taxable year beginning after December 31, 1959, shall be an amount equal to the issuance price of the stock reduced by the amount, if any, required by section 162(d) to be treated (with respect to such share) as an ordinary and necessary business expense. See section 162(d) and § 1.162-19. For purposes of this section the initial holder is the original purchaser who is issued stock of the Federal National Mortgage Association (FNMA) pursuant to section 303(c) of the Act and who appears on the books of FNMA as the initial holder. See § 1.162-19.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Pursuant to section 303(c) of the Federal National Mortgage Association Charter Act a certificate of FNMA stock is issued to A as of January 1, 1961. The issuance price of the stock was $100 and the fair market value of the stock on the date of issue was $69. A was required by section 162(d) to treat $31 as a business expense for the year 1961. The basis of the share of stock in the hands of A, the initial holder, shall be $69, the amount paid for the stock ($100) reduced by $31.

[T.D. 6690, 28 FR 12254, Nov. 19, 1963]

§ 1.1055-1 General rule with respect to redeemable ground rents.

(a) *Character of a redeemable ground rent.* For purposes of subtitle A of the Code (1) a redeemable ground rent (as defined in section 1055(c) and paragraph (b) of this section) shall be treated as being in the nature of a mortgage, and (2) real property held subject to liabilities under such a redeemable ground rent shall be treated as held subject to liabilities under a mortgage. Thus, under section 1055(a) and this paragraph, the transfer of property subject to a redeemable ground rent has the same effect as the transfer of property subject to a mortgage, the acquisition of property subject to a redeemable ground rent is to be treated the same as the acquisition of property subject to a mortgage, and the holding of property subject to a redeemable ground rent is to be treated in the same manner as the holding of property subject to a mortgage. See section 163(c) for the treatment of any annual or periodic rental payment under a redeemable ground rent as interest.

(b) *Definition of redeemable ground rent.* For purposes of subtitle A of the Code, the term "redeemable ground rent" means only a ground rent with respect to which all the following conditions are met:

(1) There is a lease of land which is assignable by the lessee without the consent of the lessor.

(2) The term of the lease is for a period in excess of 15 years, taking into account all periods for which the lease may be renewed at the option of the lessee.

(3) The lessee has a present or future right to terminate the lease and to acquire the lessor's interest in the land (i.e., to redeem the ground rent) by the payment of a determined or determinable amount, which amount is referred to in §§ 1.1055-2, 1.1055-3, and 1.1055-4 as a "redemption price". Such right must exist by virtue of State or local law. If the lessee's right to terminate the lease and to acquire the lessor's interest is not granted by State or local law but exists solely by virtue of a private agreement or privately

created condition, the ground rent is not a "redeemable ground rent".

(4) The lessor's interest in the land subject to the lease is primarily a security interest to protect the payment to him of the annual or periodic rental payments due under the lease.

(c) *Effective date.* In general, the provisions of section 1055 and paragraph (a) of this section take effect on April 11, 1963, and apply with respect to taxable years ending on or after such date. See § 1.1055-3 for rules for determining the basis of real property acquired subject to liabilities under a redeemable ground rent regardless of when such property was acquired. See also § 1.1055-4 for rules for determining the basis of a redeemable ground rent in the hands of a holder who reserved or created such ground rent in connection with a transfer, occurring before April 11, 1963, of the right to hold real property subject to liabilities under such ground rent.

[T.D. 6821, 30 FR 6216, May 4, 1965]

§ 1.1055-2 Determination of amount realized on the transfer of the right to hold real property subject to liabilities under a redeemable ground rent.

In determining the amount realized from a transfer, occurring on or after April 11, 1963, of the right to hold real property subject to liabilities under a redeemable ground rent, such ground rent shall be accounted for in the same manner as a mortgage for an amount of money equal to the redemption price of the ground rent. The provisions of this section apply in respect of any such transfer even though such ground rent was created prior to April 11, 1963. For provisions relating to the determination of the amount of and recognition of gain or loss from the sale or other disposition of property, see section 1001 and the regulations thereunder.

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1055-3 Basis of real property held subject to liabilities under a redeemable ground rent.

(a) *In general.* The provisions of section 1055(a) and paragraph (a) of § 1.1055-1 are applicable in determining the basis of real property held on or after April 11, 1963, in any case where the property at the time of acquisition was subject to liabilities under a redeemable ground rent. (See section 1055(b)(2).) Thus, if on or after April 11, 1963, a taxpayer holds real property which was subject to liabilities under a redeemable ground rent at the time he acquired it, the basis of such property in the hands of such taxpayer, regardless of when the property was acquired, will include the redeemable ground rent in the same manner as if it were a mortgage in an amount equal to the redemption price of such ground rent. Likewise, if on or after April 11, 1963, a taxpayer holds real property which was subject to liabilities under a redeemable ground rent at the time he acquired it and which has a substituted basis in his hands, the basis of the property in the hands of the taxpayer's predecessor in interest is to be determined by treating the redeemable ground rent in the same manner as a mortgage in an amount equal to the redemption price of such ground rent.

(b) *Illustrations.* The provisions of this section may be illustrated by the following examples:

Example (1). On April 11, 1963, taxpayer A held residential property which he acquired on January 15, 1963, for a purchase price of $10,000 and which, at the time he acquired it, was subject to a ground rent redeemable for a redemption price of $1,600. A's basis for the property includes the purchase price ($10,000) plus the redeemable ground rent in the same manner as if it were a mortgage for $1,600.

Example (2). In 1962, taxpayer X, a corporation, acquired real property subject to a redeemable ground rent in a transfer to which section 351 (relating to transfer of property to corporation controlled by transferor) applied and in which the basis of the property to X was the transferor's basis. X still held the property on April 11, 1963. The transferor's basis in the property is to be determined by treating the redeemable ground rent to which it was subject in the transferor's hands as if it were a mortgage.

[T.D. 6821, 30 FR 6217, May 4, 1965]

§ 1.1055-4 Basis of redeemable ground rent reserved or created in connection with transfers of real property before April 11, 1963.

(a) *In general.* In the case of a redeemable ground rent created or reserved in connection with a transfer, occurring before April 11, 1963, of the right to hold real property subject to liabilities under such ground rent, the basis of such ground rent on or after April 11, 1963, in the hands of the person who reserved or created the ground rent is the amount which was taken into account in respect of such ground rent in computing the amount realized from the transfer of such real property. Thus, if no such amount was taken into account, such basis shall be determined without regard to section 1055. (See section 1055(b)(3).)

(b) The provisions of this section may be illustrated by the following examples:

Example (1). The taxpayer, who was in the business of building houses, purchased an undeveloped lot of land for $500 and built a house thereon at a cost of $10,000. Subsequently, he transferred the right to hold the lot improved by the house for a consideration of $12,000, and an annual ground rent for such property of $120 which was redeemable for a redemption price of $2,000. The taxpayer reported a $2,000 gain on the transfer, treating the amount realized as $12,000 and his cost allocable to the interest transferred as $10,000. Since the builder did not take the redeemable ground rent into account in computing gain on the transfer, his basis for such ground rent is $500 (the cost of the land not offset against the consideration received for the transfer). Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has no gain of $1,500 in the year of sale (or redemption).

Example (2). Assume the same facts as in Example (1) except that the builder reported a gain of $3,500 on the transfer, treating the amount realized as $14,000 ($12,000 cash plus $2,000 for the redeemable ground rent) and his costs as $10,500 ($10,000 for the house and $500 for the lot). Since the taxpayer took the entire amount of the redeemable ground rent into account in computing his gain, his basis for such ground rent is $2,000. Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has no gain or loss on the transaction.

Example (3). Assume the same facts as in Example (1) except that the builder reported a gain of $3,000 on the transfer. He computed this gain by treating the amount realized as $12,000 but treating his cost allocable to the interest transferred as $12,000/$14,000ths of his total $10,500 cost, or $9,000. Since the builder still has remaining $1,500 of unallocated cost, his basis for the redeemable ground rent is $1,500. Thus, if he subsequently sells the redeemable ground rent (or if it is redeemed from him) for $2,000, he has a gain of $500 in the year of sale (or redemption).

[T.D. 6821, 30 FR 6217, May 4, 1965]

CHANGES TO EFFECTUATE F.C.C. POLICY

§ 1.1071-1 Gain from sale or exchange to effectuate policies of Federal Communications Commission.

(a)(1) At the election of the taxpayer, section 1071 postpones the recognition of the gain upon the sale or exchange of property if the Federal Communications Commission grants the taxpayer a certificate with respect to the ownership and control of radio broadcasting stations which is in accordance with subparagraph (2) of this paragraph. Any taxpayer desiring to obtain the benefits of section 1071 shall file such certificate with the Commissioner of Internal Revenue, or the district director for the internal revenue district in which the income tax return of the taxpayer is required to be filed.

(2)(i) In the case of a sale or exchange before January 1, 1958, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate the policies of such Commission with respect to the ownership and control of radio broadcasting stations.

(ii) In the case of a sale or exchange after December 31, 1957, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, such Commission with respect to the ownership and control of radio broadcasting stations.

(3) The certificate shall be accompanied by a detailed statement showing the kind of property, the date of acquisition, the cost or other basis of the

property, the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 1071 applies only in the case of a sale or exchange made necessary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 1071 does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 1071 shall be made in the manner prescribed in § 1.1071-4.

(d) For purposes of section 1071, the term "radio broadcasting" includes telecasting.

§ 1.1071-2 Nature and effect of election.

(a) *Alternative elections.* (1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in § 1.1071-3, by all or part of the gain that would otherwise be recognized under section 1033; or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 1.1071-3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) of this paragraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election in respect to a sale or exchange under section 1071 shall be irrevocable and binding for the taxable year in which the sale or exchange takes place and for all subsequent taxable years.

(b) *Application of section 1033.* (1) If the taxpayer elects, under either paragraph (a)(1) (i) or (ii) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections, shall be applicable in determining the amount of recognized gain and the basis of property required as a result of such sale or exchange. For the purposes of section 1071 and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station, do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a)(1)(i) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 1033 and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a)(1)(ii) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a)(1)(i) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 167. Such reduction of basis shall be made in accordance with and under the conditions prescribed by § 1.1071-3.

(2) In the application of section 1033 to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a)(1)(i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) *Example.* The application of the provisions of section 1071 may be illustrated by the following example:

Example. A, who makes his return on a calendar year basis, sold in 1954, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. A's basis of this stock was $75,000. The sale was certified by the Federal Communications Commission as provided in section 1071. Soon after, in the same taxable year, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which operates a radio broadcasting station. A elected in his 1954 return to treat such sale and purchase as an involuntary conversion subject to the provisions of section 1033. He also elected at the same time to reduce the basis of depreciable property by the amount of the gain that otherwise would be recognized under the provisions of section 1033, as made applicable by section 1071. The sale results in a recognized gain of $25,000 under section 1033. However, this gain is not recognized in this case because the taxpayer elected to reduce the basis of other property by the amount of the gain. This may be shown as follows:

(1) Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	25,000
Proceeds of sale	100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 1033	50,000
Realized gain, recognized under section 1033 (not to exceed the unexpended portion of proceeds of sale)	25,000
Less: Amount applied as a reduction of basis of depreciable property	25,000
Recognized gain for tax purposes	None

(2) The basis of Y Corporation stock in the hands of A is $50,000, computed in accordance with section 1033 and the regulations prescribed under that section. The $50,000 basis is computed as follows:

Basis of property sold (converted)	$75,000
Less: Amount of proceeds not expended	50,000
Balance	25,000
Plus amount of gain recognized under section 1033	$25,000
Basis of Y Corporation stock in A's hands	50,000

§ 1.1071-3 Reduction of basis of property pursuant to election under section 1071.

(a) *General rule.* (1) In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code which adjustments are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 1071, if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 167 (whether or not used in connection with a broadcasting business), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 1071 in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted bases of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain

which is not absorbed in the first application of the rule. For such purpose the "adjusted basis" of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(3) The application of the provisions of this section may be illustrated by the following example:

Example. Using the facts given in the example set forth in § 1.1071-2(c), except that the taxpayer elects to reduce the basis of depreciable property in accordance with paragraph (a)(1)(iii) of § 1.1071-2, the computation may be illustrated as follows:

Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Realized gain (recognized except for the election under § 1.1071-1)	25,000
Adjusted basis of other depreciable property in hands of A immediately after sale:	
Building	80,000
Transmitter	16,000
Fixtures	4,000
Total	100,000
Computation of reduction:	
Building (80,000/100,000) × $25,000 (gain)	20,000
Transmitter (16,000/100,000) × $25,000	4,000
Fixtures (4,000/100,000) × $25,000	1,000
Total reduction	25,000
New basis of assets:	
Building ($80,000 minus $20,000)	60,000
Transmitter ($16,000 minus $4,000)	12,000
Fixtures ($4,000 minus $1,000)	3,000
Total adjusted basis after reduction under section 1071	75,000
Realized gain upon sale of X Corporation stock	25,000
Less: Amount applied as a reduction to basis of depreciable property	25,000
Recognized gain for tax purposes	None

(b) *Special cases.* With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 1071 and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 1071. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121.

§ 1.1071-4 Manner of election.

(a) An election under the provisions of section 1071 shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation, the statement shall be signed with the corporate name, followed by the signature and title of an officer of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 1071 to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by § 1.1071-1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 1071, the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in paragraph (a) of § 1.1071-3, the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

EXCHANGES IN OBEDIENCE TO S.E.C. ORDERS

§ 1.1081-1 Terms used.

The following terms, when used in this section and §§ 1.1081-2 to 1.1083-1, inclusive, shall have the meanings assigned to them in section 1083: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities". Any other term used in this section and §§ 1.1081-2 to 1.1083-1, inclusive, which is defined in the Internal Revenue Code of 1954, shall be given the respective definition contained in such Code.

§ 1.1081-2 Purpose and scope of exception.

(a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 1002) and that the entire amount received as a dividend is to be included in gross income. (See sections 61 and 301.) Exceptions to the general rule are provided elsewhere in subchapters C and O, chapter 1 of the Code, one of which is that made by section 1081 with respect to exchanges, sales, and distributions specifically described in section 1081. Section 1081 provides the extent to which gain or loss is not to be recognized on (1) the receipt of a distribution described in section 1081(c)(2), or (2) an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b)). Section 331 provides that a distribution in liquidation of a corporation shall be treated as an exchange. Such distribution is to be treated as an exchange under the provisions of sections 1081 to 1083, inclusive. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 1081 (f).

(b) The requirements for nonrecognition of gain or loss as provided in section 1081 are precisely stated with respect to the following general types of transactions:

(1) The exchange that is provided for in section 1081 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 1081 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 1081 (c)(1), in which stock or securities are distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, or the distribution that is provided for in section 1081 (c)(2), in which a corporation distributes to a shareholder, rights to acquire common stock in a second corporation.

(4) The transfer that is provided for in section 1081 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 1081 (a) are prescribed in section 1081 (e).

(c) These exceptions to the general rule are to be strictly construed. Unless both the purpose and the specific requirements of sections 1081 to 1083, inclusive, are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under those sections. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 1081 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 1081.

(d) The application of the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 1081 (b), in the reduction of basis of certain property. The provisions of section 1082 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of such part VI, shall not be construed or applied in such a way as to defeat this purpose.

§ 1.1081-3 Exchanges of stock or securities solely for stock or securities.

The exchange, without the recognition of gain or loss, that is provided for in section 1081 (a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 1081 (a) unless the stock or securities transferred and those received are stock or securities as defined by section 1083 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 1081 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i.e., a corporation in the same holding company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 1081 (a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 1081(b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 1081(a) if it is within the provisions of section 1081(d), relating to transfers within a system group. For treatment when nonexempt property is received, see section 1081(e); for further limitations, see section 1081(f).

§ 1.1081-4 Exchanges of property for property by corporations.

(a) *Application of section 1081(b).* Section 1081(b) applies only to the transfers specified therein with respect to which section 1081(d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized section 1081(b) is inapplicable and the application of other provisions of subtitle A of the Code must be determined. See section 1081(g). If section 1081(b) is applicable, the other provisions of subchapters C and O, chapter 1 of the Code, relating to the nonrecognition of gain are inapplicable, and the conditions under which, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), (e), and (f) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.* No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 1083(e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 1083 (b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in sec-

tion 1083 (a)) and such order satisfies the requirements of section 1081 (f);

(3) The transferor corporation has filed the required consent to the regulations under section 1082(a)(2) (see paragraph (g) of this section); and

(4) The entire amount of the gain, as determined under section 1001, can be applied in reduction of basis under section 1082(a)(2).

(c) *Nonrecognition of gain; nonexempt proceeds.* If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 1083 (e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer.

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 1083 (a)) which satisfies the requirements of section 1081 (f) and which recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) of this section.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.* If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.* For the purposes of paragraphs (c) and (d) of this section, the following are treated as expenditures for property other than nonexempt property:

(1) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer);

(2) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(3) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(f) *Recognition of gain in part; inability to reduce basis.* If the transaction would be within the provisions of paragraph (b) or (c) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 1082(a)(2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 1082(a)(2).

(g) *Consent to regulations under section 1082(a)(2).* To be entitled to the benefits of the provisions of section 1081(b), a corporation must file with its return for the taxable year in which the transfer occurs a consent to have the basis of its property adjusted under section 1082(a)(2) (see § 1.1082-3), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made on Form 982 in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.* If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the district director, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the district director may specify, and such bond with such surety as the district director may require, in an amount not in excess of double the estimated maximum income tax which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6751, 29 FR 11356, Aug. 6, 1964; T.D. 7517, 42 FR 58935, Nov. 14, 1977]

§ 1.1081-5 Distribution solely of stock or securities.

(a) *In general.* If, without any surrender of his stock or securities as defined in section 1083(f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 1081(c)(1) if it is within the provisions of section 1081(d), relating to transfers within a system group. A distribution is also not within the provisions of section 1081(c)(1) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 1081(f).

(b) *Special rule.* (1) If there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, no gain to the shareholder from the receipt of the rights shall be recognized, but only if all the following requirements are met:

(i) The rights are received by the shareholder without the surrender by the shareholder of any stock in the distributing corporation,

(ii) Such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79c) that the distributing corporation is exempt from any provision or provisions of such act, and

(iii) Before January 1, 1958, the distributing corporation disposes of all the common stock in the second corporation which it owns.

(2) The distributing corporation shall, as soon as practicable, notify the district director in whose district the corporation's income tax return and supporting data was filed (see paragraph (g) of § 1.1081-11), as to whether or not the requirement of subparagraph (1)(iii) of this paragraph has been met. If such requirement has not been met, the periods of limitation (sections 6501 and 6502) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of such rights to acquire stock, shall include one year immediately following the date of

such notification; and assessment and collection shall be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment and collection.

§ 1.1081-6 Transfers within system group.

(a) The nonrecognition of gain or loss provided for in section 1081(d)(1) is applicable to an exchange of property for other property (including money and other nonexempt property) between corporations which are all members of the same system group. The term "system group" is defined in section 1083 (d).

(b) Section 1081 (d)(1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in § 1.1081-2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in part VI (section 1081 and following), subchapter O, chapter 1 of the Code, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 1081 (d)(1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 1081 (d)(1) will, because of the basis provisions of section 1082 (d), affect the cost to the member of such discharge or its equivalent. Thus, section 1081 (d)(1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

(d) The provisions of paragraph (c) of this section may be illustrated by the following example:

Example. Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 1081 (d)(1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see § 1.1082-6) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(e) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 1081 (d)(1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 1081 (d)(1) and also may be considered to be within some other provisions of section 1081, it shall be considered that only the provisions of section 1081 (d)(1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 1.1081-7 Sale of stock or securities received upon exchange by members of system group.

(a) Section 1081(d)(2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 1081(d)(1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 1081 (d)(2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 1081 (d)(2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange to which section 1081 (d)(1) is applicable the Y Corporation on June 1, 1954, issued to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance was $90,000 and its basis to the X Corporation was $75,000. On December 1, 1954, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1954. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock, only $10,000 is recognized (the difference between the fair market value of the stock when acquired and the amount for which it was sold), since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities. If in this example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 1.1081-8 Exchanges in which money or other nonexempt property is received.

(a) Under section 1081(e)(1), if in any exchange (not within any of the provisions of section 1081(d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 1081 (a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) of this section and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 1081 (e)(2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§ 1.1081-9 Requirements with respect to order of Securities and Exchange Commission.

The term "order of the Securities and Exchange Commission" is defined in section 1083(a). In addition to the requirements specified in that definition, section 1081(f) provides that, except in the case of a distribution described in section 1081 (c)(2), the provisions of section 1081 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b)).

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 1081, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is essential and must be met if gain or loss is not to be recognized upon the transaction.

§ 1.1081-10 Nonapplication of other provisions of the Internal Revenue Code of 1954.

The effect of section 1081(g) is that an exchange, sale, or distribution which is within section 1081 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, the purpose being to prevent overlapping of those provisions and other provisions of subtitle A of the Code. In other words, if by virtue of section 1081 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 1081, regardless of what the result might have been if part VI (section 1081 and following), subchapter O, chapter 1 of the Code, had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 1082, regardless of what the basis of such property might have been under section 1011 if such part VI had not been enacted. On the other hand, if section 1081 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of subtitle A of the Code as if such part VI had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of subtitle A of the Code as if such part VI had not been enacted.

§ 1.1081-11 Records to be kept and information to be filed with returns.

(a) *Exchanges; holders of stock or securities.* Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) *Exchanges; corporations subject to S.E.C. orders.* Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange, computed in accordance with the last sentence in paragraph (b) of § 1.316-2.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other dispositions made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(10) The term "exchange" shall, whenever occurring in this paragraph, be read as "exchange, expenditure, or investment".

(c) *Distributions; shareholders.* Each shareholder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(3) If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(d) *Distributions; distributing corporations subject to S.E.C. orders.* Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution including—

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquisition of the stock or securities distributed, and, if any of such stock or securities were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence in paragraph (b) of § 1.316-2.

(6) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) *Sales by members of system groups.* Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including—

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(f) *Section 1081 (c)(2) distributions; shareholders.* Each shareholder who receives a distribution described in section 1081 (c)(2) (concerning rights to acquire common stock) shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all the facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of the rights received upon the distribution, stated on the basis of their fair market value at the date of the distribution.

(g) *Section 1081 (c)(2) distributions; distributing corporations.* Every corporation making a distribution described in section 1081(c)(2) (concerning rights to acquire common stock) shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributees upon such distribution including—

(1) A copy of the arrangement forming the basis for the issuance of the order by the Securities and Exchange Commission.

(2) A copy of the order issued by the Securities and Exchange Commission pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79c).

(3) A certified copy of the corporate resolution authorizing the arrangement and the distribution.

(4) A statement of the amount of the rights distributed to each shareholder, stated on the basis of their fair market value at the date of the distribution.

(5) The date of acquisition of the stock with respect to which such rights are distributed, and if any were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(6) The amount of the undistributed earnings and profits of the distributing corporation accumulated after February 28, 1913, to the time of the distribution computed in accordance with the last sentence in paragraph (b) of § 1.316-2.

(h) *General requirements.* Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution to which sections 1081 to 1083, inclusive, are applicable, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

§ 1.1082-1 Basis for determining gain or loss.

(a) For determining the basis of property acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798), see such section (before its amendment by such Act).

(b) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 1082 (other than subsection (a)(2)), or section 372 (other than subsection (a)(2)) of the Internal Revenue Code of 1939 after its amendments, the basis shall be that prescribed in section 1082 with respect to such property. However, in the case of property acquired in a transaction described in section 1081(c)(2), this paragraph is applicable only if the property was acquired in a distribution made in a taxable year subject to the Internal Revenue Code of 1954.

(c) Section 1082 makes provisions with respect to the basis of property acquired in a transfer in connection with which the recognition of gain or loss is prohibited by the provisions of section 1081 with respect to the whole or any part of the property received. In general, and except as provided in § 1.1082-3, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also § 1.1081-2.

§ 1.1082-2 Basis of property acquired upon exchanges under section 1081 (a) or (e).

(a) In the case of an exchange of stock or securities for stock or securities as described in section 1081 (a), if no part of the gain or loss upon such exchange was recognized under section 1081, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 1081 (a), gain to the taxpayer was recognized under section 1081 (e) on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 1081 (e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 1081(e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 1081(a), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 1082 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 1082 (b).

(e) For purposes of this section, any reference to section 1081 shall be deemed to include a reference to corresponding provisions of prior internal revenue laws.

§ 1.1082-3 Reduction of basis of property by reason of gain not recognized under section 1081(b).

(a) *Introductory.* In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code, and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section 1082(a)(2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 1081(b). Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 1081(b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Code prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 1081(b), property is not considered as having a basis capable of reduction if—

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 1081 (b).

(b) *General rule.* (1) Section 1082(a)(2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(2) If any of the property in the first category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.* (1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 1082(a)(2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its income tax return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982 shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of section 1081(b)(4).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; as amended by T.D. 7517, 42 FR 58935, Nov. 14, 1977]

§ 1.1082-4 Basis of property acquired by corporation under section 1081 (a), 1081(b), or 1081(e) as contribution of capital or surplus, or in consideration for its own stock or securities.

If, in connection with an exchange of stock or securities for stock or securities as described in section 1081(a), or an exchange of property for property as described in section 1081(b), or an exchange as described in section 1081(e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 1082(b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 1081 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§ 1.1082-5 Basis of property acquired by shareholder upon tax-free distribution under section 1081(c) (1) or (2).

(a) *Stock or securities.* If there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 1081 (c)(1) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of this subparagraph, stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security, so that different values may properly be assigned thereto, will constitute a difference in class.

(b) *Stock rights.* If there was distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, and if by virtue of section 1081 (c)(2) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock rights so distributed to the shareholder. The basis of such stock and the stock rights received upon the distribution shall be determined in accordance with the following:

(1) The cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock rights distributed, in proportion to the respective values thereof at the time the rights are issued.

(2) The basis for determining gain or loss from the sale of a right, or from the sale of a share of stock in respect of which the distribution is made, will be the quotient of the cost or other basis, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares of such stock held.

(c) *Cross reference.* As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see § 1.1082-6.

§ 1.1082-6 Basis of property acquired under section 1081(d) in transactions between corporations of the same system group.

(a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 1081 (d)(1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made. Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 1.1081-6.

(b) An exception to the general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

(c) The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Suppose the A Corporation has property with an adjusted basis of $600,000 and, in an exchange in which section 1081 (d)(1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 550,000/1,000,000ths of $600,000.

Example (2). Suppose that in example (1) the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the example remain the same. In such case, the basis to the A Corporation of the stock or securities in the

B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, because this amount is less than the amount established as 500,000/1,000,000ths of $1,100,000 or $550,000.

§ 1.1083–1 Definitions.

(a) *Order of the Securities and Exchange Commission.* (1) An order of the Securities and Exchange Commission as defined in section 1083(a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938 (52 Stat. 447)), and must be issued under the authority of section 11(b) or 11(e) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b), (e)), to effectuate the provisions of section 11(b) of such Act. In all cases the order must become or have become final in accordance with law; i.e., it must be valid, outstanding, and not subject to further appeal. See further sections 1083(a) and 1081(f).

(2) Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

> Sec. 11. *Simplification of holding company systems.* * * *
>
> (b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:
>
> (1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—
>
> (A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;
>
> (B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and
>
> (C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.
>
> The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.
>
> (2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company. The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

(3) Section 11(e) of the Public Utility Holding Company Act of 1935 provides:

> Sec. 11. *Simplification of holding company systems.* * * *
>
> (e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company

or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *Registered holding company, holding-company system, and associate company.* (1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79e), any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. As used in this part, the term "registered holding company" means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a)(7) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(7)), a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i.e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i.e., an electric utility company or a gas utility company as defined by such act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935 (15 U.S.C. ch. 2C). An electric utility company is defined by section 2 (a)(3) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(3)) to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a)(4) of such act (15 U.S.C. 79b (a)(4)), to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term "holding company system" has the meaning assigned to it by section 2 (a)(9) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(9)), and hence means any holding company, together with all its subsidiary companies (i.e., subsidiary companies within the meaning of section 2(a)(8) of such act (15 U.S.C. 79b (a)(8)), which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79m). The term "member company" is defined by action 2 (a)(14) of such act (15 U.S.C. 79b (a)(14)), to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term "associate company" has the meaning assigned to it by section 2 (a)(10) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b (a)(10)), and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *Majority-owned subsidiary company.* The term "majority-owned subsidiary company" is defined in section 1083 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *System group.* The term "system group" is defined in section 1083 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than (1) stock which is preferred as to both dividends and assets, and (2) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations, and if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 1083(c), as a general rule both types of ownership tests must be met under section 1083(d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *Nonexempt property.* The term "nonexempt property" is defined by section 1083(e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt

property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example—

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not nonexempt property within the meaning of section 1083(e) (1), (2), or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 1083 (e) (2) or (3). The term "the right to receive money" includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *Stock or securities.* The term "stock or securities" is defined in section 1083(f) for the purposes of part VI (section 1081 and following), subchapter O, chapter 1 of the Code. As therein defined, the term includes voting trust certificates and stock rights or warrants.

WASH SALES OF STOCK OR SECURITIES

§ 1.1091-1 Losses from wash sales of stock or securities.

(a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule: The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word "acquired" as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

(g) For purposes of determining under this section the 61-day period applicable to a short sale of stock or securities, the principles of paragraph (a) of § 1.1233-1 for determining the consummation of a short sale shall generally apply except that the date of entering into the short sale shall be deemed to be the date of sale if, on the date of entering into the short sale, the taxpayer owns (or on or before such date has entered into a contract or option to acquire) stock or securities identical to those sold short and subsequently delivers such stock or securities to close the short sale.

(h) The following examples illustrate the application of this section:

Example (*1*). A, whose taxable year is the calendar year, on December 1, 1954, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1954, purchased 100 additional shares for $9,000. On January 3, 1955, he sold the 100 shares purchased on December 1, 1954, for $9,000. Because of the provisions of section 1091, no loss from the sale is allowable as a deduction.

Example (*2*). A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1954, he purchased 25 additional shares of such stock for $1,125. On January 3, 1955, he sold for $4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss of $1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750−$3,000, or $750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares ($1,250−$1,000, or $250) is deductible subject to the limitations provided in sections 267 and 1211. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1955, is $2,500 (the cost of 50 of the shares sold on January 3, 1955) + $750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1954, and the selling price ($2,000) of 50 of the shares sold on January 3, 1955), or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1955, is $1,250+$125, or $1,375. See § 1.1091-2.

Example (*3*). A, whose taxable year is the calendar year, on September 15, 1954, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1956, for $4,000. On each of the four days from February 15, 1956, to February 18, 1956, inclusive, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1956, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956. In determining the period for which the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956, were held, there is to be included the period for which the 100 shares purchased on September 15, 1954, and sold on February 1, 1956, were held.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6926, 32 FR 11468, Aug. 9, 1967]

§ 1.1091-2 Basis of stock or securities acquired in "wash sales".

(a) *In general.* The application of section 1091(d) may be illustrated by the following examples:

Example (1). A purchased a share of common stock of the X Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 1091. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2). A purchased a share of common stock of the Y Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 1091. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

(b) *Special rule.* For a special rule as to the adjustment to basis required under section 1091(d) in the case of wash sales involving certain regulated investment company stock for which there is an average basis, see paragraph (e)(3)(iii) (*c*) and (*d*) of § 1.1012-1.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7129, 36 FR 12738, July 7, 1971]

DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT OF 1956

§ 1.1101-1 In general.

The Bank Holding Company Act of 1956 (12 U.S.C. ch. 17) requires, in certain cases, the separation of interests in nonbanking businesses held by a bank holding company, as defined in section 2(a) of the Act (12 U.S.C. 1841(a)), from its interests in banking and closely related businesses. In order to facilitate such separation, part VIII (section 1101 and following), subchapter O, chapter 1 of the Code, provides, to a limited extent, for the nonrecognition of gain on the receipt, by shareholders or security holders of a qualified bank holding corporation, of property distributed pursuant to a certification by the Board of Governors of the Federal Reserve System that such distribution is necessary or appropriate to effectuate the policies of the Act. The provisions of such part VIII of subchapter O supersede other provisions of chapter 1 of the Code only to the extent that such provisions of part VIII specifically apply to a transaction and, where they are not applicable, do not prevent the application of any other provisions of law under which nonrecognition of gain may occur. For example, a bank holding company may retain, under section 4(c)(5) of the Act (12 U.S.C. 1843(c)(5)), up to five percent of the voting stock of another company. In such a case, a distribution of all the stock of such other company pursuant to a certification by the Board would result in nonrecognition of gain under section 1101 as to only 95 percent of such distribution. However, assuming the distribution is one that qualifies for nonrecognition of gain under section 355, relating to distribution of stock and securities of a controlled corporation, as well as under section 1101, nonrecognition of gain may be obtained under section 355 with respect to the five percent not qualifying for nonrecognition under section 1101. Further, the provisions of such part VIII of subchapter O do not provide for nonrecognition of gain to the distributing bank holding company. Accordingly, gain will be recognized to the distributing corporation in appropriate cases. For example, if a bank holding company, in a distribution qualifying under section 1101, distributes installment obligations, LIFO inventory, or property subject to a liability in excess of its adjusted basis, gain may be recognized to the corporation under section 453(d) or section 311. If, pursuant to section 1101(c)(2) or 1101(c)(3), a bank holding company places the property to be disposed of in a newly created corporation in exchange for all its stock which is then distributed by the bank holding company to its shareholders, the extent, if any, to which gain will be recognized to the bank holding company on either the exchange or the subsequent distribution is not affected by such part VIII of subchapter O and must be determined under other provisions of the Internal Revenue Code. For example, if the conditions of section 351 are satisfied, the exchange of property for stock will result in nonrecognition of gain to the bank holding company under that section.

[T.D. 6587, 27 FR 34, Jan. 4, 1962]

§ 1.1101-2 Certification by Board.

(a) *Requirement of certification.* Part VIII (section 1101 and following), subchapter O, chapter 1 of the Code, is applicable only with respect to distributions and exchanges by a qualified bank holding corporation as defined in section 1103(b). A bank holding company shall be treated as a qualified bank holding corporation only if the Board of Governors of the Federal Reserve System issues a certification that the company satisfies the requirements of section 1103 (b). (See 12 CFR 222.5(c).)

(b) *Nonrecognition of gain.* Distributions of property (other than stock and securities in a corporation created in accordance with the provisions of section 1101(c)(2) or (c)(3)) will not result in nonrecognition of gain to the shareholders and security holders of a bank holding company under section 1101(a)(1) or (b)(1) unless, before the distribution, the Board has issued a certification pursuant to section 1101(a)(1)(B) or (b)(1)(B), whichever is applicable. Distributions of stock and securities in a corporation created in accordance with section 1101(c)(2) or (c)(3) will not result in nonrecognition of gain to the shareholders and security holders of a bank holding company under section 1101(a)(2) or (b)(2) unless, before the exchange described in section 1101(c)(2)(A) or (c)(3)(A), the Board has issued a certification pursuant to section 1101(c)(2)(C) or (c)(3)(C), whichever is applicable. Further, unless a final certification is also made by the Board in accordance with section 1101(e), section 1101(a) or (b) will not apply to any distribution made by a bank holding company. Provisionally, however, pending the issuance of such final certification, section 1101(a) or (b) shall be deemed applicable to distributions otherwise qualifying under such part VII of subchapter O which are made within the period described in section 1101(e)(1) or (e)(2)(B), whichever is applicable.

(c) *Limitations.* The period of limitations in section 6501 with respect to any deficiency resulting solely from the receipt by a shareholder or security holder of property, in a distribution certified by the Board in accordance with section 1101(a)(1)(B), (b)(1)(B), (c)(2)(C), or (c)(3)(C), shall not expire prior to the period prescribed in section 1102(b), notwithstanding that the shareholder or security holder relied on a provision of law other than section 1101(a) or (b), for example section 355, to obtain nonrecognition of gain on the distribution. (See § 1.1102-2.)

[T.D. 6587, 27 FR 35, Jan. 4, 1962]

§ 1.1101-3 Tax avoidance.

(a) *Recognition of gain.* Irrespective of whether the transaction meets the other requirements of sections 1101, 1102, and 1103, a distribution will not qualify for nonrecognition of gain pursuant to the provisions of section 1101 if, in connection with such distribution, the distributing corporation retains, or transfers to any corporation after May 15, 1955, property pursuant to a plan one of the principal purposes of which is the distribution of earnings and profits of a corporation so as to avoid the Federal income tax on dividends. A certification that a particular distribution of property is necessary or appropriate in order to comply with the Bank Holding Company Act of 1956 (12 U.S.C. ch. 17) shall not be considered as permitting nonrecognition of gain where such distribution is a part of a plan to distribute earnings and profits in avoidance of the Federal income tax on dividends.

(b) *Continuity and other factors.* Section 1101 contemplates a continuity of the enterprise as modified and a continuity of interest in all or part of the property received or retained on the part of those who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. Whether or not a distribution is made under section 1101 in such a manner as to be in avoidance of Federal income tax is a question to be decided in the light of all the facts and circumstances surrounding the transaction. Some of the factors which may evidence a tax avoidance plan in appropriate circumstances are the following:

(1) A company making acquisitions of property shortly before May 15, 1955, in anticipation of the legislation in order to qualify under the Bank Holding Company Act of 1956.

(2) A greatly disproportionate shift to banking or nonbanking assets shortly before or after May 15, 1955, from the normal course of holdings or any unusual shift within such groups of assets that is inconsistent with prior holdings, particularly if made to such assets that are or may be more readily marketable.

(3) A separation of assets, the acquisition of which was substantially financed out of the earnings of particular properties, from such properties (whether or not such properties are retained), particularly where said assets are in the form of cash or highly marketable securities, stocks, or other investments, and where such separation is not necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1956.

(4) A transfer of "other property" in an exchange described in section 1101(c)(2) or (c)(3), which property is greater in amount than that reasonably required by the newly created corporation for its working capital or is disproportionate to or inconsistent with the holding operations previously engaged in.

(5) An indication that a liquidation of either of the corporations separated pursuant to section 1101(c)(2) or 1101(c)(3) is contemplated or that dominant shareholders thereof intended to sell the stock received or retained.

(6) An indication that dominant shareholders contemplated the sale of property distributed directly.

A shift of assets to a corporation to be separated will not in itself establish a plan to avoid tax if such action is consistent with the holding operations previously engaged in and in conformity with good business practice. Similarly, a reasonable transfer of cash and securities to a corporation availed of under section 1101(c)(2) or 1101(c)(3) for the reasonable working capital needs of a newly organized corporation will not, by itself, establish an attempt to distribute earnings and profits. Where it is established that a contribution to capital was made after May 15, 1955, and prior to the enactment of the Bank Holding Company Act of 1956 with one of the principal purposes of distributing earnings and profits of any corporation, such action will not in itself cause the proportionate remainder of a distribution to fail to qualify for treatment under section 1101. (See section 1101(d)(3).)

[T.D. 6587, 27 FR 35, Jan. 4, 1962]

§ 1.1101-4 Records to be kept and information to be filed with returns.

Each stock or security holder who receives stock or securities or other property upon a distribution made by a qualified bank holding corporation under section 1101 shall maintain records of, and file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of, all facts pertinent to the nonrecognition of gain upon such distribution, including—

(a) Name and address of the corporation from which the distribution is received; the date the distribution is received; and that the distribution was made pursuant to the Bank Holding Company Act of 1956.

(b) A statement of the name or designation, type, class, number, and fair market value on the date of receipt of the stock or securities or other property received upon the distribution and a record of the disposition made thereof, or of any stock or securities retained in the distributing corporation in the year of receipt.

(c) If preferred stock is exchanged for preferred stock or securities are exchanged for securities within the meaning of section 1101(a)(2)(A) or section 1101(b)(2)(A), a statement of the terms and amount of such newly issued securities or preferred stock, as well as of those surrendered.

(d) A statement as to the distributee's holdings immediately prior to the record date for the distribution of each class of stock or securities outstanding of the distributing corporation, together with the date and manner of acquisition thereof.

(e) The value of the distributing corporation's stock per share or securities immediately prior tc and after the distribution.

In the case of a return filed on or before January 4, 1962, such information shall be filed on or before April 4, 1962, by the taxpayer with the district director for the internal revenue district in which such return was filed.

[T.D. 6587, 27 FR 35, Jan. 4, 1962]

§ 1.1102-1 Basis of property acquired in distributions by qualified bank holding corporations.

In the case of a distribution to a shareholder with respect to stock, without the surrender by such shareholder of stock, to which section 1101(a) or (b) applies, the sum of the basis of all the stock in the distributing corporation held immediately after the transaction plus the basis of all the nonrecognition property received in the transaction shall be the same as the basis of all the stock in such corporation held immediately before the transaction allocated in proportion to the respective fair market value of each. In the case of an exchange to which section 1101(a) or (b) applies, in which property is received by a shareholder in exchange for stock or by a security holder in exchange for securities, the basis of all the property received in the exchange and as a part thereof shall be the same as the adjusted basis of the stock or securities exchanged, increased by—

(a) The amount of the property received as part of the exchange which was treated as a dividend, and

(b) The amount of gain to the taxpayer recognized on the property received as part of the exchange (not including any portion of such gain which was treated as a dividend).

The basis, in a case involving an exchange, must be apportioned to the properties received, and for this purpose there must be allocated to such other property received as part of the exchange (not permitted to be received without the recognition of gain) an amount of such basis equivalent to the fair market value of such other property at the date of the exchange. Any other property received in connection with a transaction under section 1101 on which gain is realized shall receive a basis in accordance with whichever Code section may be applicable to that portion of the transaction.

[T.D. 6587, 27 FR 36, Jan. 4, 1962]

§ 1.1102-2 Filing of notification under section 1102(b) by qualified bank holding corporations.

Every distributing corporation which is certified as being a qualified bank holding corporation under section 1103(b) shall, as soon as practical, by written statement notify the Commissioner of Internal Revenue, Washington 25, D.C., Attention: T:R:R, that the period (including extensions thereof granted by the Board of Governors of the Federal Reserve System) prescribed in section 4(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(a)), or section 1101(e)(2)(B) of the Code, whichever is applicable, has expired. In order for such statement to satisfy the requirements for notification under section 1102(b), there shall be included a statement certifying that the district director for the district in which the distributing corporation filed its return for the taxable year of distribution has been advised of all facts pertinent to the divestment of assets under part VIII (section 1101 and following), subchapter O, chapter I of the Code, including the following:

(a) Name and address of the distributing corporation.

(b) A copy of the plan of divestment forming the basis of the issuance by the Board of any certification under section 1101(a)(1)(B), section 1101(b)(1)(B), section 1101(c)(2)(C), or section 1101(c)(3)(C), as the case may be.

(c) A copy of any such certifications issued to the distributing corporation by the Board.

(d) A certified copy of the corporate resolution authorizing every distribution under section 1101.

(e) Identification and date of acquisition by the distributing corporation of all property distributed under section 1101.

(f) Identification and date of acquisition by the distributing corporation of all property which was transferred to a new corporation under section 1101(c)(2) or (3).

(g) If the date of acquisition in paragraph (e) or (f) of this section was after May 15, 1955, a complete statement of details surrounding the acquisition. If any of such property was acquired in a distribution under section 1101, a copy of the certification covering such distribution.

(h) A statement as to whether any of the distributions under section 1101 contained installment obligations, LIFO inventory, or property either subject to a liability in excess of its basis or in connection with the receipt of which any shareholder assumed a liability in excess of its basis. If so, the statement shall include complete details, including dates of distribution.

(i) [Reserved]

(j) Fair market value of the distributing corporation's outstanding securities and stock per share immediately after a distribution.

(k) The amount of the undistributed earnings and profits of the distributing corporation accumulated after February 28, 1913, to date of transfer to a new corporation in an exchange to which section 1101(c)(2) or (3) applies.

(l) If property was transferred to a new corporation under the provisions of section 1101(c)(2) or (3), a statement giving the value of the assets transferred together with the value of assets retained. If cash was transferred, a complete substantiation thereof.

(m) If stock in a controlled corporation within the meaning of section 1102(c)(3) is distributed under section 1101(a)(1) or (b)(1), a statement giving the accumulated earnings and profits of the controlled corporation (or deficit in earnings as the case may be) immediately prior to the distribution.

(n) A copy of the final certification if issued to the distributing corporation by the Board pursuant to section 1101(e).

(o) The date of expiration of the period (including extensions thereof) prescribed in section 4(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(a)), or section 1101(e)(2)(B), whichever is applicable.

(p) A statement showing, for the 5-year period preceding any exchange or distribution described in section 1101, the amount of income and expenditures attributable to each of the respective activities and holdings of the bank holding company and further showing the holdings and activities, after the distributions and exchanges described in section 1101, of the bank holding company and the corporations the stock of which is distributed under section 1101.

The periods of limitation (section 6501) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of property by shareholders in a distribution certified by the Board under subsection (a), (b), or (c) of section 1101 shall not expire until 5 years following the date of the notification required under section 1102(b) and this section.

[T.D. 6637, 28 FR 1764, Feb. 26, 1963]

§ 1.1102-3 Allocation of earnings and profits in certain distributions by qualified bank holding corporations.

(a) *Exchanges described in section 1101(c)(2) or (3).* Under section 1102(c), if a qualified bank holding corporation transfers property to a newly created corporation in exchange for all of its stock in a transaction described in section 1101(c)(2)(A) or (3)(A) and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section

1101(a)(2) or (b)(2) applies, the earnings and profits of the bank holding corporation immediately before the transaction shall be allocated between such bank holding corporation and the controlled corporation. Such allocation generally shall be made in proportion to the fair market value of the assets retained by the bank holding corporation and the assets of the controlled corporation immediately after the transaction. In a proper case, allocation shall be made in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case. The term "net basis" means the basis of the assets less liabilities assumed or liabilities to which such assets are subject. The part of the earnings and profits of the taxable year of the bank holding corporation in which the transaction occurs allocable to the controlled corporation shall be included in the computation of the earnings and profits of the first taxable year of the controlled corporation ending after the date of the transaction.

(b) *Distribution of stock in a controlled corporation under section 1101(a)(1) or (b)(1).* If a qualified bank holding corporation distributes stock of a controlled corporation (as defined in section 1102(c)(3)) in a distribution or exchange to which section 1101(a)(1) or (b)(1) applies, the earnings and profits of the bank holding corporation shall be decreased by the lesser of the following amounts:

(1) The amount by which the earnings and profits of the bank holding corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a transaction to which section 1101(c)(2) or (3) applied and immediately thereafter distributed the stock of such new corporation under section 1101(a)(2) or (b)(2) or,

(2) The net worth of the controlled corporation. (For this purpose the term "net worth" means the sum of the bases of all of the properties plus cash minus all liabilities.)

If the earnings and profits of the controlled corporation immediately before the transaction are less than the amount of the decrease in earnings and profits of the bank holding corporation (including the case in which the controlled corporation has a deficit) the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of such decrease. If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in the earnings and profits of the bank holding corporation they shall remain unchanged.

(c) *Deficits.* A deficit of the distributing corporation shall in no case be allocated to a controlled corporation.

[T.D. 6587, 27 FR 37, Jan. 4, 1962]

BLANK PAGE

FINDING AIDS

A list of CFR titles, subtitles, chapters, subchapters and parts and an alphabetical list of agencies publishing in the CFR are included in the CFR Index and Finding Aids volume to the Code of Federal Regulations which is published separately and revised semiannually (January 1 and July 1.)

Table of CFR Titles and Chapters
Alphabetical List of Agencies Appearing in the CFR
List of CFR Sections Affected

BLANK PAGE

Table of CFR Titles and Chapters

(As of March 20, 1981)

Title 1—General Provisions

Chap.	
I	Administrative Committee of the Federal Register (Parts 0-49)
II	Office of the Federal Register (Parts 50-299)
III	Administrative Conference of the United States (Parts 300-399)
IV	Miscellaneous Agencies (Part 400-end)

Title 2—[Reserved]

Title 3—The President

	Proclamations
	Executive Orders
	Presidential Documents Other Than Proclamations and Executive Orders
I	Executive Office of the President (Parts 100 and 101)

Title 4—Accounts

I	General Accounting Office (Parts 0-99)
II	Federal Claims Collection Standards (General Accounting Office—Department of Justice) (Parts 100-299)
III	Cost Accounting Standards Board (Parts 300-499)

Title 5—Administrative Personnel

I	Office of Personnel Management (Parts 0-1199)
II	Merit Systems Protection Board (Parts 1200-1299)
III	Office of Management and Budget (Parts 1300-1399)
IV	Advisory Committee on Federal Pay (Parts 1400-1499)
V	The International Organizations Employees Loyalty Board (Parts 1500-1599)
VII	Advisory Commission on Intergovernmental Relations (Parts 1700-1799)
IX	Appalachian Regional Commission (Parts 1900-1999)
XI	United States Soldiers' and Airmen's Home (Parts 2100-2199)
XIV	Federal Labor Relations Authority, General Counsel of the Federal Labor Relations Authority and Federal Service Impasses Panel (Parts 2400-2499)

Title 5—Administrative Personnel—Continued

Chap.	
XV	Office of Administration, Executive Office of the President (Parts 2500-2599)

Title 6—Economic Stabilization

VI	Assistant Secretary for Administration, Department of the Treasury (Parts 600-699)
VII	Council on Wage and Price Stability (Parts 700-799)

Title 7—Agriculture

	Subtitle A—Office of the Secretary of Agriculture (Parts 0-25a)
	Subtitle B—Regulations of the Department of Agriculture
I	Agricultural Marketing Service (Standards, Inspections, Marketing Practices), Department of Agriculture (Parts 26-209)
II	Food and Nutrition Service, Department of Agriculture (Parts 210-299)
III	Animal and Plant Health Inspection Service, Department of Agriculture (Parts 300-399)
IV	Federal Crop Insurance Corporation, Department of Agriculture (Parts 400-499)
V	Agricultural Research Service, Department of Agriculture (Parts 500-599)
VI	Soil Conservation Service, Department of Agriculture (Parts 600-699)
VII	Agricultural Stabilization and Conservation Service (Agricultural Adjustment), Department of Agriculture (Parts 700-799)
VIII	Federal Grain Inspection Service, Department of Agriculture (Parts 800-899)
IX	Agricultural Marketing Service (Marketing Agreements and Orders; Fruits, Vegetables, Nuts), Department of Agriculture (Parts 900-999)
X	Agricultural Marketing Service (Marketing Agreements and Orders; Milk), Department of Agriculture (Parts 1000-1199)
XI	Agricultural Marketing Service (Marketing Agreements and Orders; Miscellaneous Commodities), Department of Agriculture (Parts 1200-1299)
XII	Statistical Reporting Service (Agricultural Statistics), Department of Agriculture (Parts 1300-1399)
XIV	Commodity Credit Corporation, Department of Agriculture (Parts 1400-1499)
XV	Foreign Agricultural Service, Department of Agriculture (Parts 1500-1599)
XVI	Rural Telephone Bank, Department of Agriculture (Parts 1600-1699)
XVII	Rural Electrification Administration, Department of Agriculture (Parts 1700-1799)
XVIII	Farmers Home Administration, Department of Agriculture (Parts 1800-2099)

Chap.	
XXI	Foreign Economic Development Service, Department of Agriculture (Parts 2100–2199)
XXIV	Board of Contract Appeals, Department of Agriculture (Parts 2400–2499)
XXV	Office of the General Sales Manager, Department of Agriculture (Parts 2500–2599)
XXVI	Office of the Inspector General, Department of Agriculture (Parts 2600–2699)
XXVIII	Food Safety and Quality Service, Department of Agriculture (Parts 2800–2899)
XXIX	Office of Energy, Department of Agriculture (Parts 2900–2999)
XXX	Office of Operations and Finance, Department of Agriculture (Parts 3000–3099)
XXXI	Office of Environmental Quality, Department of Agriculture (Parts 3100–3199)

Title 8—Aliens and Nationality

I	Immigration and Naturalization Service, Department of Justice (Parts 0–499)

Title 9—Animals and Animal Products

I	Animal and Plant Health Inspection Service, Department of Agriculture (Parts 0–199)
II	Agricultural Marketing Service (Packers and Stockyards), Department of Agriculture (Parts 200–299)
III	Food Safety and Quality Service, Meat and Poultry Inspection, Department of Agriculture (Parts 300–399)

Title 10—Energy

I	Nuclear Regulatory Commission (Parts 0–199)
II	Department of Energy (Parts 200–699)
III	Department of Energy (Parts 700–899)
X	Department of Energy (General Provisions) (Parts 1000–1199)
XV	Office of the Federal Inspector for the Alaska Natural Gas Transportation System (Parts 1500–1599)

Title 11—Federal Elections

I	Federal Election Commission (Parts 0–9099)

Title 12—Banks and Banking

I	Comptroller of the Currency, Department of the Treasury (Parts 0–199)
II	Federal Reserve System (Parts 200–299)
III	Federal Deposit Insurance Corporation (Parts 300–399)
IV	Export-Import Bank of the United States (Parts 400–499)

Title 12—Banks and Banking—Continued

Chap.	
V	Federal Home Loan Bank Board (Parts 500-599)
VI	Farm Credit Administration (Parts 600-699)
VII	National Credit Union Administration (Parts 700-799)
VIII	Federal Financing Bank (Parts 800-899)
XI	Federal Financial Institutions Examination Council (Parts 1100-1199)
XII	Depository Institutions Deregulation Committee (Parts 1200-1299)

Title 13—Business Credit and Assistance

I	Small Business Administration (Parts 100-199)
III	Economic Development Administration, Department of Commerce (Parts 300-399)
IV	Chrysler Corporation Loan Guarantee Board (Parts 400-499)
V	Regional Action Planning Commissions (Parts 500-599)

Title 14—Aeronautics and Space

I	Federal Aviation Administration, Department of Transportation (Parts 0-199)
II	Civil Aeronautics Board (Parts 200-399)
V	National Aeronautics and Space Administration (Parts 1200-1299)

Title 15—Commerce and Foreign Trade

	Subtitle A—Office of the Secretary of Commerce (Parts 0-19)
	Subtitle B—Regulations Relating to Commerce and Foreign Trade
I	Bureau of the Census, Department of Commerce (Parts 20-199)
II	National Bureau of Standards, Department of Commerce (Parts 200-299)
III	International Trade Administration, Department of Commerce (Parts 300-399)
IV	Foreign-Trade Zones Board (Parts 400-499)
V	United States Metric Board (Parts 500-599)
VI	Bureau of Industrial Economics, Department of Commerce (Parts 600-699)
VIII	Bureau of Economic Analysis, Department of Commerce (Parts 800-899)
IX	National Oceanic and Atmospheric Administration, Department of Commerce (Parts 900-999)
XII	United States Travel Service, Department of Commerce (Parts 1200-1299)
XIII	East-West Foreign Trade Board (Parts 1300-1999)

Title 15—Commerce and Foreign Trade—Continued

SUBTITLE C—Regulations Relating to Foreign Trade Agreements

Chap.

XX Office of the United States Trade Representative (Parts 2000-2099)

SUBTITLE D—Regulations Relating to Telecommunications and Information

XXIII National Telecommunications and Information Administration, Department of Commerce (Parts 2300-2399)

Title 16—Commercial Practices

I Federal Trade Commission (Parts 0-999)

II Consumer Product Safety Commission (Parts 1000-1799)

Title 17—Commodity and Securities Exchanges

I Commodity Futures Trading Commission (Parts 0-199)

II Securities and Exchange Commission (Parts 200-399)

Title 18—Conservation of Power and Water Resources

I Federal Energy Regulatory Commission, Department of Energy (Parts 0-399)

III Delaware River Basin Commission (Parts 400-499)

IV Office of Water Resources Research, Department of the Interior (Parts 500-599)

VI Water Resources Council (Parts 701-799)

VIII Susquehanna River Basin Commission (Parts 800-899)

XIII Tennessee Valley Authority (Parts 1300-1399)

Title 19—Customs Duties

I United States Customs Service, Department of the Treasury (Parts 0-199)

II United States International Trade Commission (Parts 200-299)

III International Trade Administration, Department of Commerce (Parts 300-399)

Title 20—Employees' Benefits

I Office of Workers' Compensation Programs, Department of Labor (Parts 0-199)

II Railroad Retirement Board (Parts 200-399)

III Social Security Administration, Department of Health and Human Services (Parts 400-499)

IV Employees' Compensation Appeals Board, Department of Labor (Parts 500-599)

V Employment and Training Administration, Department of Labor (Parts 600-699)

VI Employment Standards Administration, Department of Labor (Parts 700-799)

Title 20—Employees' Benefits—Continued

Chap.	
VII	Benefits Review Board, Department of Labor (Parts 800-899)
VIII	Joint Board for the Enrollment of Actuaries (Parts 900-999)

Title 21—Food and Drugs

I	Food and Drug Administration, Department of Health and Human Services (Parts 0-1299)
II	Drug Enforcement Administration, Department of Justice (Parts 1300-1399)

Title 22—Foreign Relations

I	Department of State (Parts 0-199)
II	Agency for International Development, International Development Cooperation Agency (Parts 200-299)
III	Peace Corps (Parts 300-399)
IV	International Joint Commission, United States and Canada (Parts 400-499)
V	International Communication Agency (Parts 500-599)
VI	United States Arms Control and Disarmament Agency (Parts 600-699)
VII	Overseas Private Investment Corporation (Parts 700-799)
VIII	Employee-Management Relations Commission (Parts 800-899)
IX	Foreign Service Grievance Board (Parts 901-999)
X	Inter-American Foundation (Parts 1000-1099)
XI	International Boundary and Water Commission, United States and Mexico, United States Section (Part 1100-1199)
XII	United States International Development Cooperation Agency (Parts 1200-1299)
XIII	Board for International Broadcasting (Parts 1300-1399)
XIV	Foreign Service Labor Relations Board;Federal Labor Relations Authority; General Counsel of the Federal Labor Relations Authority; and the Foreign Service Impasse Disputes Panel (Parts 1400-1499)

Title 23—Highways

I	Federal Highway Administration, Department of Transportation (Parts 0-999)
II	National Highway Traffic Safety Administration and Federal Highway Administration, Department of Transportation (Parts 1200-1299)

Title 24—Housing and Urban Development

	SUBTITLE A—Office of the Secretary, Department of Housing and Urban Development (Parts 0-99)
	SUBTITLE B—Regulations Relating to Housing and Urban Development
I	Office of Assistant Secretary for Equal Opportunity, Department of Housing and Urban Development (Parts 100-199)

Title 24—Housing and Urban Development—Continued

Chap.	
II	Office of Assistant Secretary for Housing—Federal Housing Commissioner, Department of Housing and Urban Development (Parts 200–299)
III	Government National Mortgage Association, Department of Housing and Urban Development (Parts 300–399)
IV	Office of Assistant Secretary for Housing Management, Department of Housing and Urban Development (Parts 400–499)
V	Office of Assistant Secretary for Community Planning and Development, Department of Housing and Urban Development (Parts 500–599)
VI	Office of Assistant Secretary for Community Planning and Development, Department of Housing and Urban Development (Parts 600–699)
VII	New Community Development Corporation, Department of Housing and Urban Development (Parts 700–799)
VIII	Low-Income Housing, Department of Housing and Urban Development (Parts 800–899)
IX	Office of Interstate Land Sales Registration, Department of Housing and Urban Development (Parts 1700–1799)
X	Solar Energy and Energy Conservation Bank, Department of Housing and Urban Development (Parts 1800–1899)
XV	Mortgage Insurance and Loan Programs Under the Emergency Homeowners' Relief Act, Department of Housing and Urban Development (Parts 2700–2799)
XX	Office of Assistant Secretary for Neighborhoods, Voluntary Associations and Consumer Protection, Department of Housing and Urban Development (Parts 3200–3699)
XXV	Neighborhood Reinvestment Corporation (Parts 4100–4199)

Title 25—Indians

I	Bureau of Indian Affairs, Department of the Interior (Parts 0–299)
II	Indian Arts and Crafts Board, Department of the Interior (Parts 300–399)
IV	Navajo and Hopi Indian Relocation Commission (Part 700–799)

Title 26—Internal Revenue

I	Internal Revenue Service, Department of the Treasury (Parts 0–699)

Title 27—Alcohol, Tobacco Products and Firearms

I	Bureau of Alcohol, Tobacco and Firearms, Department of the Treasury (Parts 0–299)

Title 28—Judicial Administration

I	Department of Justice (Parts 0–199)
III	Federal Prison Industries, Department of Justice (Parts 300–399)

Title 28—Judicial Administration—Continued

Chap.	
V	Bureau of Prisons, Department of Justice (Parts 500-599)

Title 29—Labor

	SUBTITLE A—Office of the Secretary of Labor (Parts 0-99)
	SUBTITLE B—Regulations Relating to Labor
I	National Labor Relations Board (Parts 100-199)
II	Office of the Assistant Secretary for Labor-Management Relations, Department of Labor (Parts 200-299)
III	National Railroad Adjustment Board (Parts 300-399)
IV	Office of Labor-Management Standards Enforcement, Department of Labor (Parts 400-499)
V	Wage and Hour Division, Department of Labor (Parts 500-899)
IX	Construction Industry Collective Bargaining Commission (Parts 900-999)
X	National Mediation Board (Parts 1200-1299)
XII	Federal Mediation and Conciliation Service (Parts 1400-1499)
XIV	Equal Employment Opportunity Commission (Parts 1600-1699)
XVII	Occupational Safety and Health Administration, Department of Labor (Parts 1900-1999)
XX	Occupational Safety and Health Review Commission (Parts 2100-2400)
XXV	Pension and Welfare Benefit Programs, Department of Labor (Parts 2500-2599)
XXVI	Pension Benefit Guaranty Corporation (Parts 2600-2699)
XXVII	Federal Mine Safety and Health Review Commission (Parts 2700-2799)

Title 30—Mineral Resources

I	Mine Safety and Health Administration, Department of Labor (Parts 0-199)
II	Geological Survey, Department of the Interior (Parts 200-299)
III	Board of Surface Mining and Reclamation Appeals, Department of the Interior (Parts 300-399)
VI	Bureau of Mines, Department of the Interior (Parts 600-699)
VII	Office of Surface Mining Reclamation and Enforcement, Department of the Interior (Parts 700-999)

Title 31—Money and Finance: Treasury

	SUBTITLE A—Office of the Secretary of the Treasury (Parts 0-50)
	SUBTITLE B—Regulations Relating to Money and Finance
I	Monetary Offices, Department of the Treasury (Parts 51-199)
II	Fiscal Service, Department of the Treasury (Parts 200-399)
IV	Secret Service, Department of the Treasury (Parts 400-499)
V	Office of Foreign Assets Control, Department of the Treasury (Parts 500-599)

Chap.	
VI	Bureau of Engraving and Printing, Department of the Treasury (Parts 600–699)
VII	Federal Law Enforcement Training Center, Department of the Treasury (Part 700–end)

Title 32—National Defense

	SUBTITLE A—Department of Defense
I	Office of the Secretary of Defense (Parts 0–399)
V	Department of the Army (Parts 400–699)
VI	Department of the Navy (Parts 700–799)
VII	Department of the Air Force (Parts 800–1099)
	SUBTITLE B—Other Regulations Relating to National Defense
XII	Defense Logistics Agency (Parts 1200–1299)
XVI	Selective Service System (Parts 1600–1699)
XIX	Central Intelligence Agency (Parts 1900–1999)
XX	Information Security Oversight Office (Parts 2000–2099)
XXI	National Security Council (Parts 2100–2199)
XXIV	Office of Science and Technology Policy (Parts 2400–2499)
XXVII	Office for Micronesian Status Negotiations (Parts 2700–2799)
XXVIII	Office of the Vice President of the United States (Parts 2800–2899)

Title 33—Navigation and Navigable Waters

I	Coast Guard, Department of Transportation (Parts 0–199)
II	Corps of Engineers, Department of the Army (Parts 200–399)
IV	Saint Lawrence Seaway Development Corporation, Department of Transportation (Parts 400–499)

Title 34—Education

	SUBTITLE A—Office of the Secretary, Department of Education (Parts 1–99)
	SUBTITLE B—Regulations of the Offices of the Department of Education
I	Office for Civil Rights, Department of Education (Parts 100–199)
II	Office of Elementary and Secondary Education, Department of Education (Parts 200–299)
III	Office of Special Education and Rehabilitative Services, Department of Education (Parts 300–399)
IV	Office of Vocational and Adult Education, Department of Education (Parts 400–499)
V	Office of Bilingual Education and Minority Languages Affairs, Department of Education (Parts 500–599)
VI	Office of Postsecondary Education, Department of Education (Parts 600–699)

Title 34—Education—Continued

Chap.	
VII	Office of Educational Research and Improvement, Department of Education (Parts 700-799)
VIII	Office of Education for Overseas Dependents, Department of Education (Parts 800-899)

Title 35—Panama Canal

I	Panama Canal Regulations (Parts 0-299)

Title 36—Parks, Forests, and Public Property

I	National Park Service, Department of the Interior (Parts 0-199)
II	Forest Service, Department of Agriculture (Parts 200-299)
III	Corps of Engineers, Department of the Army (Parts 300-399)
IV	American Battle Monuments Commission (Parts 400-499)
V	Smithsonian Institution (Parts 500-599)
VII	Library of Congress (Parts 700-799)
VIII	Advisory Council on Historic Preservation (Parts 800-899)
IX	Pennsylvania Avenue Development Corporation (Parts 900-999)
X	Commission of Fine Arts (Parts 1000-1099)
XI	Architectural and Transportation Barriers Compliance Board (Part 1100-1199)
XII	Heritage Conservation and Recreation Service, Department of the Interior (Part 1200-1299)

Title 37—Patents, Trademarks, and Copyrights

I	Patent and Trademark Office, Department of Commerce (Parts 0-199)
II	Copyright Office, Library of Congress (Parts 200-299)
III	Copyright Royalty Tribunal (Parts 300-399)

Title 38—Pensions, Bonuses, and Veterans' Relief

I	Veterans Administration (Parts 0-99)

Title 39—Postal Service

I	United States Postal Service (Parts 0-999)
III	Postal Rate Commission (Parts 3000-3099)

Title 40—Protection of Environment

I	Environmental Protection Agency (Parts 0-799)
IV	Low-Emission Vehicle Certification Board (Parts 1400-1499)
V	Council on Environmental Quality (Parts 1500-1599)

Title 41—Public Contracts and Property Management

Chap.	SUBTITLE A—Federal Procurement Regulations System
1	Federal Procurement Regulations (Parts 1-1—1-30)
3	Department of Health and Human Services (Parts 3-1—3-57)
4	Department of Agriculture (Parts 4-1—4-50)
5	General Services Administration (Part 5-1)
5A	Office of Acquisition Policy, General Services Administration (Parts 5A-1—5A-76)
5B	Office of Acquisition Policy, General Services Administration (Parts 5B-1—5B-63)
6	Department of State (Parts 6-1—6-60)
7	Agency for International Development, International Development Cooperation Agency (Parts 7-1—7-60)
8	Veterans Administration (Parts 8-1—8-95)
9	Department of Energy (Parts 9-1—9-53)
10	Department of the Treasury (Parts 10-12—10-60)
12	Department of Transportation (Parts 12-1—12-99)
13	Department of Commerce (Parts 13-1—13-4)
14	Department of the Interior (Parts 14-1—14-63)
14H	Bureau of Indian Affairs, Department of the Interior (Parts 14H-1—14H-70)
14R	Office of Water Research and Technology, Department of the Interior (Part 14R-9)
15	Environmental Protection Agency (Parts 15-1—15-60)
18	National Aeronautics and Space Administration (Parts 18-1—18-52)
19	International Communication Agency (Parts 19-1—19-60)
20	Nuclear Regulatory Commission (Part 20-1)
22	Community Services Administration (Parts 22-1—22-60)
23	United States Arms Control and Disarmament Agency (Parts 23-1—23-52)
24	Department of Housing and Urban Development (Parts 24-1—24-50)
25	National Science Foundation (Parts 25-1—25-50)
28	Department of Justice (Part 28-1)
29	Department of Labor (Parts 29-1—29-70)
34	Department of Education (Parts 34-1—34-30)
44	Federal Emergency Management Agency (Parts 44-1—44-30)
	SUBTITLE B—Other Provisions Relating to Public Contracts
50	Public Contracts, Department of Labor (Parts 50-201—50-210)
51	Committee for Purchase from the Blind and Other Severely Handicapped (Parts 51-1—51-8)
60	Office of Federal Contract Compliance Programs, Equal Employment Opportunity, Department of Labor (Parts 60-1—60-741)

Title 41—Public Contracts and Property Management—Continued

SUBTITLE C—Federal Property Management Regulations System

Chap.

101 Federal Property Management Regulations (Parts 101-1—101-50)

105 General Services Administration (Parts 105-1—105-735)

109 Department of Energy (Parts 109-1—109-60)

114 Department of the Interior (Parts 114-1—114-60)

115 Environmental Protection Agency (Part 115-1)

128 Department of Justice (Parts 128-1—128-50)

SUBTITLE D—Other Provisions Relating to Property Management [Reserved]

Title 42—Public Health

I Public Health Service, Department of Health and Human Services (Parts 0-199)

III Saint Elizabeths Hospital, Department of Health and Human Services (Parts 300-399)

IV Health Care Financing Administration, Department of Health and Human Services (Parts 400-499)

Title 43—Public Lands: Interior

SUBTITLE A—Office of the Secretary of the Interior (Parts 0-199)

SUBTITLE B—Regulations Relating to Public Lands

I Water and Power Resources Service, Department of the Interior (Parts 200-499)

II Bureau of Land Management, Department of the Interior (Parts 1600-9299)

Title 44—Emergency Management and Assistance

I Federal Emergency Management Agency (Parts 0-399)

IV Department of Commerce and Department of Transportation (Parts 400-499)

Title 45—Public Welfare

SUBTITLE A—Department of Health and Human Services, General Administration (Parts 0-99)

SUBTITLE B—Regulations Relating to Public Welfare

I Department of Education (Parts 100-199)

II Office of Family Assistance (Assistance Programs), Department of Health and Human Services (Parts 200-299)

III Office of Child Support Enforcement (Child Support Enforcement Program), Department of Health and Human Services (Parts 300-399)

IV Office of Refugee Resettlement, Department of Health and Human Services (Parts 400-499)

Title 45—Public Welfare—Continued

Chap.	
V	Foreign Claims Settlement Commission of the United States (Parts 500-599)
VI	National Science Foundation (Parts 600-699)
VII	Commission on Civil Rights (Parts 700-799)
VIII	Office of Personnel Management (Parts 800-899)
X	Community Services Administration (Parts 1000-1099)
XI	National Foundation on the Arts and the Humanities (Parts 1100-1199)
XII	ACTION (Parts 1200-1299)
XIII	Office of Human Development Services, Department of Health and Human Services (Parts 1300-1399)
XVI	Legal Services Corporation (Parts 1600-1699)
XVII	National Commission on Libraries and Information Science (Parts 1700-1799)
XVIII	Harry S. Truman Scholarship Foundation (Parts 1800-1899)
XIX	National Commission on the Observance of International Women's Year (Parts 1900-1999)
XXI	Commission of Fine Arts (Parts 2100-2199)

Title 46—Shipping

I	Coast Guard, Department of Transportation (Parts 0-199)
II	Maritime Administration, Department of Commerce (Parts 200-399)
III	Coast Guard (Great Lakes Pilotage), Department of Transportation (Parts 400-499)
IV	Federal Maritime Commission (Parts 500-599)

Title 47—Telecommunication

I	Federal Communications Commission (Parts 0-199)
II	Office of Science and Technology Policy and National Security Council (Parts 200-299)

Title 48—[Reserved]

Title 49—Transportation

	Subtitle A—Office of the Secretary of Transportation (Parts 0-99)
	Subtitle B—Other Regulations Relating to Transportation
I	Research and Special Programs Administration, Department of Transportation (Parts 100-199)
II	Federal Railroad Administration, Department of Transportation (Parts 200-299)
III	Federal Highway Administration, Department of Transportation (Parts 300-399)
IV	Coast Guard, Department of Transportation (Parts 400-499)

Title 49—Transportation—Continued

Chap.	
V	National Highway Traffic Safety Administration, Department of Transportation (Parts 500-599)
VI	Urban Mass Transportation Administration, Department of Transportation (Parts 600-699)
VIII	National Transportation Safety Board (Parts 800-899)
IX	United States Railway Association (Parts 900-999)
X	Interstate Commerce Commission (Parts 1000-1399)

Title 50—Wildlife and Fisheries

I	United States Fish and Wildlife Service, Department of the Interior (Parts 0-199)
II	National Marine Fisheries Service, National Oceanic and Atmospheric Administration, Department of Commerce (Parts 200-299)
III	International Regulatory Agencies (Fishing and Whaling) (Parts 300-399)
IV	Joint Regulations (United States Fish and Wildlife Service, Department of the Interior and National Marine Fisheries Service, National Oceanic and Atmospheric Administration, Department of Commerce); Endangered Species Committee Regulations (Parts 400-499)
V	Marine Mammal Commission (Parts 500-599)
VI	Fishery Conservation and Management, National Oceanic and Atmospheric Administration, Department of Commerce (Parts 600-699)

CFR Index

Subject/Agency Index

List of CFR Titles, Chapters, Subchapters, and Parts

Parallel Tables of Statutory Authorities and Rules

Acts Requiring Publication in the Federal Register

Alphabetical List of Agencies Appearing in the CFR

(As of March 20, 1981)

Agency	CFR Title, Subtitle or Chapter
ACTION	45, XII
Acquisition Policy, Office of	41, 5A, 5B
Administrative Committee of the Federal Register	1, I
Administrative Conference of the United States	1, III
Advisory Commission on Intergovernmental Relations	5, VII
Advisory Committee on Federal Pay	5, IV
Advisory Council on Historic Preservation	36, VIII
Agency for International Development	22, II; 41, 7
Agricultural Marketing Service	7, I, IX, X, XI; 9, II
Agricultural Research Service	7, V
Agricultural Stabilization and Conservation Service	7, VII
Agriculture Department	
Agricultural Marketing Service	7, I, IX, X, XI; 9, II
Agricultural Research Service	7, V
Agricultural Stabilization and Conservation Service	7, VII
Animal and Plant Health Inspection Service	7, III; 9, I, III
Commodity Credit Corporation	7, XIV
Contract Appeals, Board of	7, XXIV
Energy, Office of	7, XXIX
Environmental Quality, Office of	7, XXXI
Farmers Home Administration	7, XVIII
Federal Crop Insurance Corporation	7, IV
Federal Grain Inspection Service	7, VIII
Federal Procurement Regulations System	41, 4
Food and Nutrition Service	7, II
Food Safety and Quality Service	7, XXVIII; 9, III
Foreign Agricultural Service	7, XV
Foreign Economic Development Service	7, XXI
Forest Service	36, II
General Sales Manager, Office of	7, XXV
Inspector General, Office of	7, XXVI
Operations and Finance, Office of	7, XXX
Rural Electrification Administration	7, XVII
Rural Telephone Bank	7, XVI
Secretary of Agriculture, Office of	7, Subtitle A
Soil Conservation Service	7, VI
Statistical Reporting Service	7, XII
Air Force Department	32, VII
Alaska Natural Gas Transportation System, Office of the Federal Inspector	10, XV
Alcohol, Tobacco and Firearms, Bureau of	27, I
American Battle Monuments Commission	36, IV
Animal and Plant Health Inspection Service	7, III; 9, I
Appalachian Regional Commission	5, IX
Architectural and Transportation Barriers Compliance Board	36, XI
Arms Control and Disarmament Agency, U.S.	22, VI; 41, 23
Army Department	32, V
Engineers, Corps of	33, II; 36, III
Benefits Review Board	20, VII

Agency	CFR Title, Subtitle or Chapter
Bilingual Education and Minority Languages Affairs, Office of	34, V
Blind and Other Severely Handicapped, Committee for Purchases from	41, 51
Board for International Broadcasting	22, XIII
Budget, Office of Management and	5, III
Census Bureau	15, I
Central Intelligence Agency	32, XIX
Child Support Enforcement, Office of	45, III
Chrysler Corporation Loan Guarantee Board	13, IV
Civil Aeronautics Board	14, II
Civil Rights Commission	45, VII
Civil Rights, Office for (Education Department)	34, I
Claims Collection Standards, Federal	4, II
Coast Guard	33, I; 46, I, III; 49, IV
Commerce Department	
Census Bureau	15, I
Economic Analysis, Bureau of	15, VIII
Economic Development Administration	13, III
Endangered Species Committee	50, IV
Federal Procurement Regulations System	41, 13
Fishery Conservation and Management	50, VI
Industrial Economics, Bureau of	15, VI
International Trade Administration	15, III; 19, III
Maritime Administration	46, II
National Bureau of Standards	15, II
National Defense	44, IV
National Marine Fisheries Service	50, II, IV
National Oceanic and Atmospheric Administration	15, IX; 50, II, IV
National Telecommunications and Information Administration	15, XXIII
Patent and Trademark Office	37, I
Secretary of Commerce, Office of	15, Subtitle A
United States Travel Service	15, XII
Commission on the Review of the National Policy Toward Gambling	1, IV
Committee for Purchase from Blind and Other Severely Handicapped	41, 51
Commodity Credit Corporation	7, XIV
Commodity Futures Trading Commission	17, I
Community Planning and Development, Office of Assistant Secretary for	24, V, VI
Community Services Administration	41, 22; 45, X
Comptroller of the Currency	12, I
Construction Industry Collective Bargaining Commission	29, IX
Consumer Product Safety Commission	16, II
Contract Appeals, Board of	7, XXIV
Copyright Office	37, II
Copyright Royalty Tribunal	37, III
Cost Accounting Standards Board	4, III
Council on Environmental Quality	40, V
Council on Wage and Price Stability	6, VII
Customs Service, United States	19, I
Defense Department	32, Subtitle A
Air Force Department	32, VII
Army Department	32, V; 33, II; 36, III
Defense Civil Preparedness Agency	32, XVIII
Engineers, Corps of	33, II; 36, III
Navy Department	32, VI
Secretary of Defense, Office of	32, I
Defense Logistics Agency	32, XII
Defense Manpower Commission	1, IV
Delaware River Basin Commission	18, III
Depository Institutions Deregulation Committee	12, XII
Drug Enforcement Administration	21, II
East-West Foreign Trade Board	15, XIII

Agency	CFR Title, Subtitle or Chapter
Economic Analysis, Bureau of	15, VIII
Economic Development Administration	13, III
Education, Department of	45, I
Bilingual Education and Minority Languages Affairs, Office of	34, V
Civil Rights, Office for	34, I
Education for Overseas Dependents, Office of	34, VIII
Educational Research and Improvement, Office of	34, VII
Elementary and Secondary Education, Office of	34, II
Federal Procurement Regulations System	41, 34
Postsecondary Education, Office of	34, VI
Secretary of Education, Office of	34, Subtitle A
Special Education and Rehabilitative Services, Office of	34, III
Vocational and Adult Education, Office of	34, IV
Education for Overseas Dependents, Office of	34, VIII
Educational Research and Improvement, Office of	34, VII
Elementary and Secondary Education, Office of	34, II
Employee Benefits Security, Office of	29, XXV
Employee-Management Relations Commission	22, VIII
Employees' Compensation Appeals Board	20, IV
Employees Loyalty Board, International Organizations	5, V
Employment and Training Administration	20, V
Employment Standards Administration	20, VI
Endangered Species Committee	50, IV
Energy, Department of	10, II, III, X; 41, 109
Federal Energy Regulatory Commission	18, I
Federal Procurement Regulations System	41, 9
Energy, Office of, Department of Agriculture	7, XXIX
Engineers, Corps of	33, II; 36, III
Engraving and Printing, Bureau of	31, VI
Environmental Protection Agency	40, I; 41, 15, 115
Environmental Quality, Office of (Agriculture Department)	7, XXXI
Equal Employment Opportunity	41, 60
Equal Employment Opportunity Commission	29, XIV
Equal Opportunity, Office of Assistant Secretary for	24, I
Executive Office of the President	3, I
Administration, Office of	5, XV
Export-Import Bank of the United States	12, IV
Family Assistance, Office of	45, II
Farm Credit Administration	12, VI
Farmers Home Administration	7, XVIII
Federal Aviation Administration	14, I
Federal Claims Collection Standards	4, II
Federal Communications Commission	47, I
Federal Contract Compliance, Office of	41, 60
Federal Crop Insurance Corporation	7, IV
Federal Deposit Insurance Corporation	12, III
Federal Election Commission	11, I
Federal Emergency Management Agency	41, 44; 44, I
Federal Energy Regulatory Commission	18, I
Federal Financial Institutions Examination Council	12, XI
Federal Financing Bank	12, VIII
Federal Grain Inspection Service	7, VIII
Federal Highway Administration	23, I, II; 49, III
Federal Home Loan Bank Board	12, V
Federal Inspector for the Alaska Natural Gas Transportation System, Office of	10, XV
Federal Labor Relations Authority, and General Counsel of the Federal Labor Relations Authority	5, XIV; 22,XIV
Federal Law Enforcement Training Center	31, VII
Federal Maritime Commission	46, IV
Federal Mediation and Conciliation Service	29, XII
Federal Mine Safety and Health Review Commission	29, XXVII
Federal Pay, Advisory Committee on	5, IV
Federal Prison Industries	28, III
Federal Procurement Regulations	41, I

Agency	CFR Title, Subtitle or Chapter
Federal Procurement Regulations System	41, Subtitle A
Federal Property Management Regulations	41, 101
Federal Property Management Regulations System	41, Subtitle C
Federal Railroad Administration	49, II
Federal Register, Administrative Committee of	1, I
Federal Register, Office of	1, II
Federal Reserve System	12, II
Federal Services Impasses Panel	5, XIV
Federal Trade Commission	16, I
Fine Arts Commission	36, X; 45, XXI
Fiscal Service	31, II
Fish and Wildlife Service, United States	50, I, IV
Fishery Conservation and Management	50, VI
Fishing and Whaling, International Regulatory Agencies	50, III
Food and Drug Administration	21, I
Food and Nutrition Service	7, II
Food Safety and Quality Service,	7, XXVIII; 9, III
Foreign Agricultural Service	7, XV
Foreign Assets Control, Office of	31, V
Foreign Claims Settlement Commission of United States	45, V
Foreign Economic Development Service	7, XXI
Foreign Service Grievance Board	22, IX
Foreign Service Impasse Disputes Panel	22, XIV
Foreign Service Labor Relations Board	22, XIV
Foreign-Trade Zones Board	15, IV
Forest Service	36, II
General Accounting Office	4, I, II
General Sales Manager, Office of	7, XXV
General Services Administration	41, 5
Acquisition Policy, Office of	41, 5A, 5B
Federal Procurement Regulations System	41, 1, 5A, 5B
Federal Property Management Regulations System	41, 101, 105
Geological Survey	30, II
Government National Mortgage Association	24, III
Great Lakes Pilotage	46, III
Harry S Truman Scholarship Foundation	45, XVIII
Health and Human Services, Department of	45, Subtitle A
Child Support Enforcement, Office of	45, III
Family Assistance, Office of	45, II
Federal Procurement Regulations System	41, 3
Food and Drug Administration	21, I
Harry S Truman Scholarship Foundation	45, XVIII
Health Care Financing Administration	42, IV
Human Development Office	45, XIII
Public Health Service	42, I
Refugee Resettlement Office	45, IV
St. Elizabeths Hospital	42, III
Social Security Administration	20, III
Health Care Financing Administration	42, IV
Heritage Conservation and Recreation Service	36, XII
Housing and Urban Development, Department of	
Community Planning and Development, Office of Assistant Secretary for	24, V, VI
Equal Opportunity, Office of Assistant Secretary for	24, I
Federal Procurement Regulations System	41, 24
Government National Mortgage Association	24, III
Housing—Federal Housing Commissioner, Office of Assistant Secretary for	24, II
Housing Management, Office of Assistant Secretary for	24, IV
Interstate Land Sales Registration, Office of	24, IX
Low-Income Housing	24, VIII
Mortgage Insurance and Loan Programs Under Emergency Homeowners' Relief Act	24, XV
Neighborhoods, Voluntary Associations and Consumer Protection, Office of Assistant Secretary for	24, XX
New Community Development Corporation	24, VII

Agency	CFR Title, Subtitle or Chapter
Secretary, Office of	24, Subtitle A
Solar Energy and Energy Conservation Bank	24, X
Housing—Federal Housing Commissioner, Office of Assistant Secretary for	24, II
Housing Management, Office of Assistant Secretary for	24, IV
Human Development Services Office	45, XIII
Immigration and Naturalization Service	8, I
Indian Affairs, Bureau of	25, I; 41, 14H
Indian Arts and Crafts Board	25, II
Industrial Economics, Bureau of, Commerce Department	15, VI
Information Agency, United States	22, V; 41, 19
Information Security Oversight Office	32, XX
Inspector General, Office of, Agriculture Department	7, XXVI
Inter-American Foundation	22, X
Intergovernmental Relations, Advisory Commission on	5, VII
Interior Department	
Endangered Species Committee	50, IV
Federal Procurement Regulations System	41, 14
Federal Property Management Regulations System	41, 114
Fish and Wildlife Service, United States	50, I, IV
Geological Survey	30, II
Heritage Conservation and Recreation Service	36, XII
Indian Affairs, Bureau of	25, I; 41, 14H
Indian Arts and Crafts Board	25, II
Land Management Bureau	43, II
Mines, Bureau of	30, VI
National Park Service	36, I
Secretary of the Interior, Office of	43, Subtitle A
Surface Mining and Reclamation Appeals, Board of	30, III
Surface Mining Reclamation and Enforcement, Office of	30, VII
United States Fish and Wildlife Service	50, I, IV
Water and Power Resources Service	43, I
Water Research and Technology, Office of	41, 14R
Water Resources Research, Office of	18, IV
Internal Revenue Service	26, I
International Boundary and Water Commission, United States and Mexico	22, XI
International Communication Agency	22, V; 41, 19
International Development, Agency for	22, II; 41, 7
International Development Cooperation Agency	22, II; 41, 7
International Joint Commission, United States and Canada	22, IV
International Organizations Employees Loyalty Board	5, V
International Regulatory Agencies (Fishing and Whaling)	50, III
International Trade Administration	15, III; 19, III
International Trade Commission, United States	19, II
Interstate Commerce Commission	49, X
Interstate Land Sales Registration, Office of	24, IX
Joint Board for the Enrollment of Actuaries	20, VIII
Justice Department	28, I; 41, 128
Drug Enforcement Administration	21, II
Federal Claims Collection Standards	4, II
Federal Prison Industries	28, III
Federal Procurement Regulations System	41, 28
Immigration and Naturalization Service	8, I
Prisons, Bureau of	28, V
Labor Department	
Benefits Review Board	20, VII
Employees' Compensation Appeals Board	20, IV
Employment and Training Administration	20, V
Employment Standards Administration	20, VI
Federal Contract Compliance, Office of	41, 60
Federal Procurement Regulations System	41, 29, 50
Labor-Management Relations, Office of the Assistant Secretary	29, II
Labor-Management Standards Enforcement, Office of	29, IV
Mine Safety and Health Administration	30, I

Agency	CFR Title, Subtitle or Chapter
Occupational Safety and Health Administration	29, XVII
Pension and Welfare Benefit Programs	29, XXV
Public Contracts	41, 50
Secretary of Labor, Office of	29, Subtitle A
Wage and Hour Division	29, V
Worker's Compensation Programs, Office of	20, I
Labor Management Relations, Office of Assistant Secretary	29, II
Labor-Management Standards Enforcement, Office of	29, IV
Land Management, Bureau of	43, II
Legal Services Corporation	45, XVI
Library of Congress	36, VII
Copyright Office	37, II
Low-Emission Vehicle Certification Board	40, IV
Low-Income Housing, Department of Housing and Urban Development	24, VIII
Management and Budget, Office of	5, III
Marine Mammal Commission	50, V
Maritime Administration	46, II
Merit Systems Protection Board	5, II
Micronesian Status Negotiations, Office for	32, XXVII
Mine Safety and Health Administration	30, I
Mines, Bureau of	30, VI
Miscellaneous Agencies	1, IV
Monetary Offices	31, I
Mortgage Insurance and Loan Programs Under the Emergency Homeowners' Relief Act, Department of Housing and Urban Development	24, XV
National Aeronautics and Space Administration	14, V; 41, 18
National Bureau of Standards	15, II
National Commission on Libraries and Information Science	45, XVII
National Commission on the Observance of International Women's Year	45, XIX
National Credit Union Administration	12, VII
National Foundation on the Arts and the Humanities	45, XI
National Highway Traffic Safety Administration	23, II; 49, V
National Labor Relations Board	29, I
National Marine Fisheries Service	50, II, IV
National Mediation Board	29, X
National Oceanic and Atmospheric Administration	15, IX; 50, II, VI
National Park Service	36, I
National Railroad Adjustment Board	29, III
National Science Foundation	45, VI; 41, 25
National Security Council	32, XXI
National Security Council and Office of Science and Technology Policy	47, II
National Telecommunications and Information Administration	15, XXIII
National Transportation Safety Board	49, VIII
Navajo and Hopi Indian Relocation Commission	25, IV
Navy Department	32, VI
Neighborhood Reinvestment Corporation	24, XXV
Neighborhoods, Voluntary Associations and Consumer Protection, Office of Assistant Secretary for	29, XX
New Community Development Corporation	24, VII
Nuclear Regulatory Commission	10, I; 41, 20
Occupational Safety and Health Administration	29, XVII
Occupational Safety and Health Review Commission	29, XX
Overseas Private Investment Corporation	22, VII
Panama Canal Regulations	35, I
Patent and Trademark Office	37, I
Peace Corps	22, III
Pennsylvania Avenue Development Corporation	36, IX
Pension Benefit Guaranty Corporation	29, XXVI
Pension and Welfare Benefit Programs, Department of Labor	29, XXV
Personnel Management, Office of	5, I; 45, VIII

Agency	CFR Title, Subtitle or Chapter
Postal Rate Commission	39, III
Postal Service, United States	39, I
Postsecondary Education, Office of	34, VI
President's Commission on White House Fellowships	1, IV
Presidential Documents	3
Prisons, Bureau of	28, V
Privacy Protection Study Commission	1, IV
Procurement Regulations System, Federal	41, Subtitle A
Property Management Regulations System, Federal	41, Subtitle C
Public Contracts, Department of Labor	41, 50
Public Health Service	42, I
Railroad Retirement Board	20, II
Railway Association, United States	49, IX
Refugee Resettlement Office	45, IV
Regional Action Planning Commissions	13, V
Research and Special Programs Administration	49, I
Rural Electrification Administration	7, XVII
Rural Telephone Bank	7, XVI
Saint Elizabeths Hospital	42, III
Saint Lawrence Seaway Development Corporation	33, IV
Science and Technology Policy, Office of	32, XXIV
Science and Technology Policy, Office of, and National Security Council	47, II
Secret Service	31, IV
Securities and Exchange Commission	17, II
Selective Service System	32, XVI
Small Business Administration	13, I
Smithsonian Institution	36, V
Social Security Administration	20, III
Soil Conservation Service	7, VI
Solar Energy and Energy Conservation Bank, Department of HUD	24, X
Soldiers' and Airmen's Home, United States	5, XI
Special Education and Rehabilitative Services, Office of	34, III
Special Representative for Trade Negotiations, Office of	15, XX
State Department	22, I
Federal Procurement Regulations System	41, 6
Statistical Reporting Service, Agriculture Department	7, XII
Surface Mining and Reclamation Appeals, Board of	30,III
Susquehanna River Basin Commission	18, VIII
Tennessee Valley Authority	18, XIII
Trade Representative, United States, Office of	15, XX
Transportation, Department of	
Coast Guard	33, I; 46, I, III; 49, IV
Federal Aviation Administration	14, I
Federal Highway Administration	23, I, II; 49, III
Federal Procurement Regulations System	41, 12
Federal Railroad Administration	49, II
Highway Safety Program Standards	23, II
National Defense	44, IV
National Highway Traffic Safety Administration	23, II; 49, V
Research and Science Programs Administration	49, I
Saint Lawrence Seaway Development Corporation	33, IV
Secretary, Office of	49, Subtitle A
Urban Mass Transportation Administration	49, VI
Travel Service, United States	15, XII
Treasury Department	
Administration, Assistant Secretary for	6, VI
Alcohol, Tobacco and Firearms, Bureau of	27, I
Comptroller of the Currency	12, I
Customs Service, United States	19, I
Engraving and Printing, Bureau of	31, VI
Federal Law Enforcement Training Center	31, VII
Federal Procurement Regulations System	41, 10
Fiscal Service	31, II
Foreign Assets Control, Office of	31, V

Agency	CFR Title, Subtitle or Chapter
Internal Revenue Service	26, I
Monetary Offices	31, I
Secret Service	31, IV
Secretary of the Treasury, Office of	31, Subtitle A
Truman, Harry S, Scholarship Foundation	45, XVIII
United States and Canada, International Joint Commission	22, IV
United States Arms Control and Disarmament Agency	22, VI; 41, 23
United States Customs Service	19, I
United States Fish and Wildlife Service	50, I, IV
United States International Development Cooperation Agency	22, XII
United States International Trade Commission	19, II
United States Metric Board	15, V
United States Postal Service	39, I
United States Railway Association	49, IX
United States Soldiers' and Airmen's Home	5, XI
United States Trade Representative, Office of	15, XX
United States Travel Service	15, XII
Urban Mass Transportation Administration	49, VI
Veterans Administration	38, I; 41, 8
Vice President of the United States, Office of	32, XXVIII
Vocational and Adult Education, Office of	34, IV
Wage and Hour Division	29, V
Water and Power Resources Service	43, I
Water Research and Technology, Office of	41, 14R
Water Resources Council	18, VI
Water Resources Research, Office of	18, IV
Welfare-Pension Reports, Office of Labor-Management and	29, IV
Workers' Compensation Programs, Office of	20, I

List of CFR Sections Affected

All changes to sections of Part 1 (§§ 1.851 to 1.1200) of Title 26 of the Code of Federal Regulations which were made by documents published in the FEDERAL REGISTER since January 1, 1973, are enumerated in the following list. Entries indicate the nature of the changes effected. Page numbers refer to FEDERAL REGISTER pages. The user should consult the entries for chapters and parts as well as sections for revisions.

For the period before January 1, 1973, see "List of CFR Sections Affected, 1949-1963 and 1964-1972," which is published in three separate volumes.

1973

26 CFR

38 FR Page

No regulations issued through Mar. 31.

1973–1974

(Regulations published from April 1, 1973 through March 31, 1974)

26 CFR

	38 (39*) FR Page
1.881 Revised	32795
1.881-1 Revised	32795
1.881-2 Revised	32796
1.882 Revised	32797
1.882-1 Revised	32797
1.882-2 Revised	32798
1.882-3 Revised	32799
1.883-1 (b) and (c) revised; (d) added	32799
(b) Corrected	34203
1.884 Revised	32799
1.894 Revised	32799
1.894-1 Revised	32800
1.896 Added	32801
1.901 Revised	33073
1.901-1 (i) added	20824
1.901-2 (a) revised	33074
1.901-3 Added	33074
1.902-3 (a)(1) amended	20824
(a)(1) revised	33080
1.902-4 (a) amended	20824
1.904 Amended	33080, 33291
Corrected	34802
1.904-1 (d)(1) revised	33080
(a)(1) and (b)(1) revised	33291
1.904-2 (b)(2)(iii) and (c)(3) added	33081
(a) Revised	33292

26 CFR—Continued

	38 (39*) FR Page
1.904-3 (e) revised	33292
1.904-4 Added	33292
(b)(2)(i)(*a*)(*2*) and (iii), (c)(1)(iii), (d)(1)(iv)(*b*) and (3) table, and (e)(1)(iv) example and table and (2)(iii) tables corrected	34802
(c)(1)(iv) and (d)(2)(ii) corrected; (e)(1)(iv) amended	34803
1.904-4 *(e)(1)(iv) table corrected	3548
1.905-2 (c) added	33300
(c) Corrected	34802
1.922 Revised	20824
1.922-1 (c) added	20824
(c) Corrected	22549
1.931 Amended	20824
1.931-1 (j) added	20825
1.952 Amended	32801
1.952-1 (b) revised	32802
1.953 Amended	32802
1.954-1 (c) revised	32802
1.970-1 (b)(3) revised	32802
1.971-1 (b)(1)(viii) revised	32802
1.1014 Amended	20825
1.1014-1 (b) revised	20825
1.1014-9 Added	20825
1.1036.1 (a) amended	18540

1974–1975

(Regulations published from April 1, 1974 through March 31, 1975)

26 CFR

	39 (40†) FR Page
1.852 Amended	44972

NOTE: Symbol (*) refers to 1974 page numbers.

26 CFR—Continued

	39 (40†) FR Page
1.852-2 (b)(1) and (2)(ii) revised	44972
1.852-4 (b)(1) and (2), and (c)(3) revised	44972
1.852-9 (c)(2)(ii) revised	44217
(a)(1) Revised; (c)(3) added	44973
1.857 Amended	44974
1.857-2 (b) revised	44974
1.857-4 (b) and (e) revised	44974
1.861-2 (d) revised	18073
1.864-4 (c)(3)(i) revised	44232
1.871A Added; redesignated from and amended	44217
1.871 Redesignated as 1.871A; new 1.871 added	44217
1.871-1 Revised	44218
1.871-6 Revised	44218
1.871-7 Revised	44219
1.871-8 Revised	44221
1.871-9 Added	44222
1.871-10 Added	44222
1.871-11 Added	44224
1.871-12 Added	44225
1.871-13 Added	44226
1.872 Amended	44227
1.872-1 Revised	44228
1.872-2 Revised	44228
1.875-2 Added	44233
1.876-1 (b) and (c) revised; (d) added	44229
1.877 Revised	44229
1.878 Added	44229
1.911 (c)(1)(B), (d), and historical note revised	38371
1.912 Revised	44233
1.932 Amended	44230
1.932-1 (a)(1) revised	44230
1.959-3 (e) introductory text revised, examples (*1*) and (*2*) amended	44211
1.960-1 (c)(1)(iii), (3) and (4) (example (*6*)) added	44211
(c)(4) Amended	† 1014
1.960-2 (c)(2) and (e) (examples (*7*) and (*8*)) added	44212
(e) Amended	† 1014, 1015
(e) Tables corrected	† 2802
1.963-3 (h) (example (*2*)) revised	44214
1.964-1 (c)(3)(ii) and (4)(iv) revised	30931
1.981 Added	38371
1.981-1 Added	38372
1.981-2 Added	38373
1.981-3 Added	38374
1.991—1.992-1 Added	34402-34405

26 CFR—Continued

	39 (40†) FR Page
1.992-1 (f) revised	34405
1.992-2—1.992-4 Added	34405-34409
1.992-3 (c) and (d) corrected	36009
1.995—1.997-1 Added	35108

1975–1976

(Regulations published from April 1, 1975 through March 31, 1976)

26 CFR

	40 (41Δ) FR Page
1.861 (a)(1)(A) through (C), (a)(2)(B), (C), and 3(C)(ii) and historical note revised; (a)(1)(D) through (H) and (a)(2)(D) and (c) through (e) added	45428
1.861-2 Revised	45429
(d) corrected	48508
1.861-3 (a)(3) revised; (b) redesignated (c) and revised; new (b) and (d) added	45432
(a)(3) Corrected	48508
1.861-4 (a) and (b) revised; (d) added	45433
(a)(4) Corrected	48508
1.861-5 Revised	45434
1.861-8 (b) revised	45434
1.862-1 (a) revised	45434
Corrected	48508
1.863-6 Revised	45435
1.864-2 (b)(2)(ii) and (iv) revised	45435
1.881 Amended	50260
1.881-1 (c) revised	50260
1.895 Text and historical note revised	45435
1.895-1 Revised	45435
(e) corrected	48508
1.902-1 (c) revised	45436
1.902-3 (d)(1) added	45436
1.931 Amended	50260
1.931-1 Heading and (a)(1) revised	50260
1.932 Amended	50260
1.932-1 (a)(1) and (b) revised	50260
1.935 Added	50261
1.935-1 Added	50261
1.962-1 (b)(1)(ii) revised	12640
1.963-6 (f) revised	11020
1.994 Added	29827
1.994-1 Added	29827
1.994-2 Added	29836
(a) and (e) corrected	33972

NOTE: Symbol (†) refers to 1975 page numbers.

26 CFR—Continued

40 (41Δ) FR Page

1.1034 (a), (c) (4) and (5), (d), (h), and note revised.................. Δ6758
1.1034-1 (b)(7), (c)(1), (c)(4)(ii) and (iii), (d)(1), (g)(1), (g)(4) and (h)(2)(ii) revised................ Δ6758
1.1039-1 (a) amended................ Δ5101

1976–1977

(Regulations published from April 1, 1976 through March 31, 1977)

26 CFR

41 (42*) FR Page

1.861-3 (a)(1) revised; (a)(2) and (d) amended; (a)(5) added.........*12179
1.861-8 Revised.............................*1195
  Technical correction....................*2501
  Authority citation corrected...... *9020
1.863-3 (b)(2), (c)(3) and (4) amended.. *1214
  Technical correction....................*2501
  Authority citation corrected...... *9020
1.905-2 (a)(2) amended.................*1214
  Technical correction....................*2501
  Authority citation corrected...... *9020
1.992-1 (a) amended..................... 20654
  (a)(6) Revised; (i) added.............20654
  (a)(6) Corrected......................... 22267
1.9992-2 (a)(1)(i) amended.......... 20655
1.992-3 (a)(4) revised.................... 20655
1.994-1 (c)(6)(v), (e)(3)(i) through (iv) and (e)(5) added; (e)(6) revised.................................43152
1.995-5 (b)(5)(i) amended............ 20655

1977–1978

(Regulations published from April 1, 1977 through March 31, 1978)

26 CFR

42 (43†) FR Page

1.901-3 (b)(2)(i), (ii), and (d) amended..20130
1.902 (b), (c)(1)(A), (d) and Historical note revised; (c)(1)(B) amended..20124
1.902-1 Revised..............................20125
  (a)(2) Amended.........................30497
1.902-2 Removed...........................20129
  Redesignated from 1.902-4; (a), (b) and (c) amended; new (d) added...20130
1.902-3 Removed...........................20129

26 CFR—Continued

42 (43†) FR Page

1.902-4 Redesignated as 1.902-2; (a), (b) and (c) amended; new (d) added.. 20130
1.902-5 Removed...........................20130
1.904-1 (a)(1) and (b)(1) revised.. 30497
  (a)(1) Corrected........................ 32536
1.904-2 (a) revised........................ 30497
1.904-3 (e) revised........................ 30497
1.904-4 Heading, (a)(1), (d)(1), and (e)(2)(i)(*b*) revised; (a)(3), (4), and (5) redesignated as (a)(4), (5), and (6); new (a)(3) added; (e)(1)(iv) and (e)(2)(iii) amended.. 30497
  (d)(1)(*b*), (ii) (*b*) and (iii) (*b*) corrected.................................. 32536
1.904-5 Added............................... 30499
  (b)(1)(i)(B), (ii)(A), (ii)(B), (iii)(C), (b)(1)(v) and (2)(ii) and (c) corrected.......................32536
1.954-2 (d)(2)(ii) and (iii) and (e)(2) revised.................................34875
1.960-1 (b)(4) and (h) amended..20130
1.960-3 (a) amended..................... 20130
1.971 Removed............................ † 6603
1.971-1 (a)(1) amended............... † 6603
1.993 Removed..............................55454
1.993-1—1.993-7 Technical correction...61595
1.993-1 Added...............................55454
  (h) and (j)(2) corrected............... 60910
1.993-2 Added............................... 55459
  Corrected designated; (a)(5) corrected.................................... 60910
1.993-3 Added............................... 55461
  (g) incorrectly amended..............55469
  (a) Amended; (f)(1) revised; (g) redesignated as (i); new (g) and (h) added........................... 57309
  (a)(1) Correctly designated......60910
1.993-4 Added............................... 55464
  (a)(2)(iv) amended...................... 57311
  (a)(4) and (e)(6) corrected.......... 60910
1.993-5 Added............................... 55467
  (a)(2) and (b)(1)(ii) corrected.....60911
1.993-6 Added............................... 55468
1.993-7 Added............................... 55468
1.1081-4 (g)amended.................... 58935
1.1082-3 (c)(2) amended...............58935

NOTE: Symbol (Δ) refers to 1976 page numbers.
NOTE: Symbol (*) refers to 1977 page numbers.

NOTE: Symbol (†) refers to 1978 page numbers.

1978–1979

(Regulations published from April 1, 1978 through March 31, 1979)

26 CFR

43 (44Δ) FR Page

Chapter I

1.851 Removed 32753

1.851-2 (b) redesignated as (b) (1) and amended; (b)(2) 32753

1.861-3 (a)(5)(I)(*a*), (iii), and (v)(*b*) revised; (a)(5)(ii)(*c*) added; (a)(5)(iv)(*a*) and (*b*), (vi), and (d) amended Δ5116

1.901 Removed 40496

1.901-1 (f) revised 40496

1.952-1 (c)(2)(ii) amended 19652

1.954-3 (a)(1) amended 32754

1.959-3 (b)(3) amended 19652

1.960-1 (c)(1)(v) amended 19652

1.963-0 Added 19652

1.964-1 (c)(2), (c)(6)(iv), and undesignated texts following (b)(2)(ii) and (c)(6)(iv) amended 19652

1.964-1 Undesignated text following (c)(1)(ii) amended 19652

1.1012-1 (c)(7)(iii)(*b*) revised 47505

1979–1980

(Regulations published from April 1, 1979 through March 31, 1980)

26 CFR

44 (45*) FR Page

Ch. I Editorial changes *20795

1.851 Removed *6089

1.852 Removed *6089

1.853 Removed *6089

1.854 Removed *6089

1.855 Removed *6089

1.856 Removed *6089

1.857 Removed *6089

1.858 Removed *6089

1.861 Removed 46457

1.861-1 (a)(4) added 46457

1.861-9 Added 46457

1.862 Removed 46459

1.862-1 (c) added 46459

1.863 Removed *6089

1.864 Removed *6089

1.871A Removed *6089

1.871 Removed *6089

1.871-1 (a) amended *6928

1.871-13 (a)(1) amended *6928

1.872 Removed *6089

26 CFR—Continued

44 (45*) FR Page

1.873 Removed *6089

1.874 Removed *6089

1.875 Removed *6089

1.876 Removed *6089

1.877 Removed *6089

1.878 Removed *6089

1.879-1 Added *6928

1.881 Removed *6089

1.882 Removed *6089

1.883 Removed *6089

1.884 Removed *6089

1.892 Removed *6089

1.893 Removed *6089

1.894 Removed *6089

1.895 Removed *6089

1.896 Removed *6089

1.901-1 (f) revised 47058

1.902 Removed *6089

1.902-1 (a)(6), (b)(3), (c)(3), and (d)(3), and (k) examples (4) and (6) removed; (a)(7) and (8), and (k) example (5) redesignated as (a)(6) and (7), and (k) example (4) 60086

(b)(1)(i), (iii), and (iv), (c)(1), (d)(1), (j), (k) examples (1), (3), new (4) and (1) amended; (b)(2), (c)(2), (d)(2), (e), (f), and (k) example (2) revised 60086

1.902-2 Revised 60087

1.903 Removed *6089

1.904 Removed *6089

1.905 Removed *6089

1.911 Removed 27080

Removed *6089

1.911-1 Removed 27080

1.911-2 Removed 27080

1.912 Removed *6089

1.921 Removed *6089

1.922 Removed *6089

1.931 Removed *6089

1.932 Removed *6089

1.933 Removed *6089

1.934 Removed *6089

1.935 Removed *6089

1.936-1 Added *8588

(b) corrected *16174

1.941 Removed *6089

1.942 Removed *6089

1.943 Removed *6089

1.951 Removed *6089

1.952 Removed *6089

1.953 Removed *6089

1.954 Removed *6089

1.955 Removed *6089

NOTE: Symbol (Δ) refers to 1979 page numbers.
NOTE: Symbol (*) refers to 1980 page numbers.

26 CFR—Continued

	44 (45*) FR Page
1.956 Removed	*6089
1.957 Removed	*6089
1.958 Removed	*6089
1.959 Removed	*6089
1.960 Removed	*6089
1.960-1 (b)(4), (c)(2) examples (2) and (4), and (e) removed; (c)(4) examples (3),(5), and (6), and (f), (g), (h), and (i) redesignated as (c)(4) examples (2), (3), and (4), and (e), (f), (g), and (h)	60088
(c)(2) revised; (c)(4) examples (1), new (2), new (3), and new (4), new (h)(1)(ii), and (3) example amended	60089
1.960-2 (e) example (2) removed; (e) examples (3) through (8) redesignated as examples (2) through (7); (e) introductory text, example (1) and new examples (2) through (7) and new examples	60089
1.960-3 Nomenclature change; (c) examples (1) and (2) amended	60089
1.960-4 (f) example (4) removed; (f) examples (1), (2), and (3) amended	60089
1.960-5 (b) example amended	60089
1.960-6 (b) example amended	60089
1.960-7 Added	60089
1.961 Removed	*6089
1.962 Removed	*6089
1.963 Removed	*6089
1.964 Removed	*6089
1.970 Removed	*6089
1.971 Removed	*6089
1.972 Removed	*6089
1.981 Removed	*6089, 6929
1.981-0 Added	*6929
1.981-1 Heading revised; (a)(1) amended	*6929
1.991 Removed	*6089
1.992 Removed	*6089
1.993 Removed	*6089
1.994 Removed	*6089
1.995 Removed	*6089
1.996 Removed	*6089
1.997 Removed	*6089
1.1001 Removed	*6089
1.1002 Removed	*6089
1.1011 Removed	*6089
1.1012 Removed	*6089
1.1013 Removed	*6089

26 CFR—Continued

	44 (45*) FR Page
1.1014 Removed	*6089
1.1015 Removed	*6089
1.1016 Removed	*6089
1.1017 Removed	*6089
1.1018 Removed	*6089
1.1019 Removed	*6089
1.1020 Removed	*6089
1.1021 Removed	*6089
1.1022 Removed	*6089
1.1031(a) Removed	*6089
1.1031(b) Removed	*6089
1.1031(c) Removed	*6089
1.1031(d) Removed	*6089
1.1031(e) Removed	*6089
1.1032 Removed	*6089
1.1033(a) Removed	31013
Removed	*6089
1.1033(a)-1 Nomenclature change; (a) amended	31013
1.1033(a)-2 Nomenclature change; heading revised; (a) amended; paragraph following (c)93)(ii) added	31013
1.1033(a)-3 Removed; new 1.1033(a)-3 redesignated from 1.1033(b)-1 and amended	31013
1.1.1033(a)-4 Removed	31013
1.1033(b) Removed	31013
Removed	*6089
1.1033(b)-1 Redesignated as 1.1033(a)-3 and amended; new 1.1033(b)-1 redesignated from 1.1033(c)-1 and amended	31013
1.1033(c) Removed	31013
Removed	*6089
1.1033(c)-1 Redesignated as 1.1033(b)-1 and amended; new 1.1033(c)-1 redesignated from 1.1033(d)-1 and amended	31013
1.1033(d) Removed	31013
Removed	*6089
1.1033(d)-1 Redesignated as 1.1033(c)-1 and amended; new 1.1033(d)-1 redesignated from 1.1033(e)-1	31013
1.1033(e) Removed	31013
Removed	*6089
1.1033(e)-1 Redesignated as 1.1033(d)-1; new 1.1033(e)-1 redesignated from 1.1033(f)-1 and amended	31013
1.1033(f) Removed	31013
Removed	*6089

NOTE: Symbol (*) refers to 1980 page numbers.

26 CFR—Continued

	44 (45*) FR Page
1.1033(f)-1 Redesignated as 1.10339e)-1 and amended; new 1.1033(f)-1 redesignated from 1.1033(g)-1 and (b) redesignated as (c) and revised and new (b) added	31013
(b) corrected	38458
1.1033(g) Removed	31013
Removed	*6089
1.1033(g)-1 Redesignated as 1.1033(f)-1 and (b) redesignated as (c) and revised and new (b) added; new 1.1033(g)-1 redesignated from 1.1033(h)-1 and amended	31013
1.1033(h) Removed	31013
Removed	*6089
1.1033(h)-1 Redesignated as 1.1033(g)-1 and amended	31013
1.1034 Removed	*6089
1.1034-1 (h)(1) amended	31013
1.1035 Removed	*6089
1.1036 Removed	*6089
1.1037 Removed	*6089
1.1038 Removed	*6089
1.1039 Removed	*6089
1.1051 Removed	*6089
1.1052 Removed	*6089
1.1053 Removed	*6089
1.1054 Removed	*6089
1.1055 Removed	*6089
1.1056 Removed	*6089
1.1071 Removed	*6089
1.1081 Removed	*6089
1.1082 Removed	*6089
1.1083 Removed	*6089
1.1091 Removed	*6089
1.1101 Removed	*6089
1.1102 Removed	*6089
1.1103 Removed	*6089

1980–1981

(Regulations published from April 1, 1980 through March 31, 1981)

26 CFR

Chapter I	45 (46†) FR Page
1.852-4 (b)(1), (2)(i), (3), and (d)(1) amended	72650
1.852-10 (b)(1) amended	72650
1.856 Removed	†11265
1.856-0 Added	†11265

26 CFR—Continued

Chapter I—Continued	45 (46†) FR Page
1.856-1 (a), (b) introductory text; (1), and (4), (c), (d) introductory text, (2), (4), and (5), and (e) amended; (b) (5) and (6) redesignated as (b) (6) and (7); new (b)(5) and (f) added	†11265
1.856-2 (c)(1)(iii)(*a*) amended	72650
(b) amended; (c) revised	†11265
1.856-3 (c) amended: (h) added	†11266
1.856-4 (a) amended; (b) (1) through (4) redesignated as (b) (3) through (5) and (7); new (b) (1) and (2) added; new (b) (3) revised; new (b)(4) amended; new (b)(5) (ii) and (iii) redesignated as (b)(5)(iii) and (iv); new (b)(5) (i) and (ii) revised; new (b)(6) added	†11266
1.856-5 Added	†11268
1.856-6 Added	†11269
(c)(4) corrected	†15263
1.856-7 Added	†11274
1.856-8 Added	†11275
(c)(2) corrected	†15263
1.856-9 Added	†11276
1.857 Removed	†11277
1.857-1 (a) introductory text and (2) and (b) amended; (a)(1) revised	†11277
1.857-2 Removed; new 1.857-2 redesignated from 1.857-3 and revised	†11277
1.857-3 Redesignated as 1.857-2 and revised; new 1.857-3 added	†11277
1.857-4 (b) and (c)(1) amended	72650
Redesignated as 1.857-6	†11277
Added	†11278
1.857-5 Redesignated as 1.857-7	†11277
Added	†11278
10857-6 Redesignated as 1.857-8; new 1.857-6 redesignated from 1.857-4	†11277
(e)(1) redesignated as (e)(1)(i) and amended; (b), (c) (1), (2) and (3), and (e)(1)(i) amended; (e)(1)(ii) and (f) added	†11279
(c)(3) amended	†11283
1.857-7 Redesignated as 1.857-9; new 1.857-7 redesignated from 1.857-5	†11277
(b) amended	†11279

NOTE: Symbol (*) refers to 1980 page numbers.

NOTE: (Symbol (†) refers to 1981 page numbers.

26 CFR—Continued

Chapter I—Continued

	45 (46†) FR Page
1.857-8 Redesignated as 1.857-10; new 1.857-8 redesignated from 1.857-6	†11277
(e) amended	†11279
1.857-9 Redesignated from 1.857-7	†11277
(a) amended	†11279
1.857-10 Redesignated from 1.857-8	†11277
Amended	†11279
1.858 Removed	†11279
1.858-1 (a) and (b) revised; (d) and (e) amended	†11279
1.859-1 Added	†11280
1.859-2 Added	†11280
1.859-3 Added	†11281
1.859-4 Added	†11282
1.860-1 Added	†11282
1.861-8 (e)(2)(i) and (f)(1)(iv) revised	†1683
1.882-4 (c) added	†1683
1.882-5 Added	†1683
(d) corrected	†16100
1.892-1 Revised; redesignated in part to 1.892-2	48883
1.892-2 Added; redesignated from 1.892-1(b) (1) and (2)	48883
1.901-2 Removed	75648
1.903-1 Removed	75648
1.911-1 Added	76133
1.911-2 Added	76134
1.911-3 Added	76135
1.911-4 Added	76135
1.911-5 Added	76136
1.911-6 Added	76136
1.911-7 Added	76137
1.913-1 Added	76137
1.913-2 Added	76137
1.913-3 Added	76138
1.913-4 Added	76139
1.913-5 Added	76139
1.913-6 Added	76140
1.913-7 Added	76141
1.913-8 Added	76142
1.913-9 Added	76142
1.913-10 Added	76142
1.913-11 Added	76143

26 CFR—Continued

Chapter I—Continued

	45 (46†) FR Page
1.913-12 Added	76143
1.913-13 Added	76143
1.953-2 (d) amended	76143
1.954-2 (d)(3)(i) revised; (d)(3)(iii), (iv), and (v) and (4) added	42607
1.956-1 (b) (2) and (3) redesignated as (b) (3) and (4); new (b)(2) added	52374
1.956-2 (b)(1)(iii), (d)(1)(i) introductory text and (d)(1)(i)(*b*) revised; (b)(1)(viii) and (c)(2) redesignated as (b)(1)(x) and (c)(4); new (b)(1)(viii) and (ix) and (c) (2) and (3) added; (c)(1) and (d)(2) introductory text amended	52374
1.958-2 (a), (b)(3) and (d)(2) amended	52375
1.981-1 (a)(3) revised	76143
1.992-1 (d)(2)(i) (*a*) and (*b*) amended; eff. 4-30-81	86459
1.1001 Removed	81745
1.1001-2 Added	81744
1.1011-2 (e) added	81745
1.1012-1 (e) (3), (4) (i) and (ii) amended	72650
1.1016 Removed	57722
1.1016-5 (t) added	57722
1.1033(a)-1 (b) amended	†6925
1.1033(a)-2 (c)(3) amended	†6925
1.1033(f)-1 Redesignated as 1.1033(g)-1 and (b) and (c) redesignated as (c) and (d) and new (b) added	†6925
1.1033(g)-1 Redesignated as 1.1033(h)-1 and amended; new 1.1033(g)-1 redesignated from 1.1033(f)-1 and (b) and (c) redesignated as (c) and (d) and new (b) added	†6925
1.1033(h)-1 Redesignated from 1.1033(g)-1 and amended	†6925

Note: Symbol (†) refers to 1981 page numbers.